Income Tax Administration

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[The purpose of the annual symposium conducted by the Tax Institute is to focus attention on a major problem of taxation by affording an opportunity for discussion by informed participants representing different points of view.

The Tax Institute believes that the thoughtful papers presented herein will prove stimulating and helpful to persons seriously concerned with tax problems, who must perforce be concerned also with problems of tax administration. The publication of this volume carries with it, of course, no endorsement of the views—sometimes conflicting—of the various authors.]

FOREWORD

THE SUBJECT of this year's conference of the Tax Institute has an unusual significance. The federal income tax is higher than ever before in times of peace, state income taxes appear to be due for some increases, and a surprising number of local governments are turning to income taxes for new revenues. With the tendency for governmental budgets to rise and for taxes to continue heavy, the study of income tax administration becomes more urgent if we are to minimize inequities and attain the maximum of efficiency, certainty, and convenience in revenue administration and compliance.

There may be only limited opportunities for general tax reductions in the foreseeable future that will lighten the tax load on investment and consumption, but there are many inviting opportunities for the improvement of tax administration at the federal, state, and local levels that can make taxes more bearable. If as much as a billion dollars of income tax revenues that may be lost every year through various evasion practices could be captured by more effective administration, the taxes on those fulfilling their obligations could be lowered that much, or equivalent new taxes to finance higher budgets could be avoided. A more adequate administration of income taxes would also result in a more uniformly accurate determination of taxable income among different taxpayers and over wider areas, with consequent gains in equity and popular endorsement of income taxation.

Because of the growth of governmental budgets and the development of income taxation by federal, state, and local governments for new revenues, the overlapping of taxes has increased. Revenues may not be raised in the most equitable and

effective manner, to the disadvantage of both governments and taxpayers. It is difficult to secure the cooperation needed among our numerous taxing governments for the better coordination of income and other taxes because of the many complications arising. To a considerable extent this is an administrative problem which calls for the better planning of tax structures, the aid of tax administrators in securing appropriate tax legislation, and the cooperation of tax administrators in the solution of problems of mutual concern.

The importance of income tax administration has also increased because of the recent rapid rise of the income tax to its position as the major source of American tax revenue. In the fiscal year 1948, according to Treasury statistics, the federal income taxes provided over $31 billion, or nearly three-fourths, of the federal government's $42 billion of tax receipts. Preliminary census data indicate that the states obtained over $1 billion from income taxes in the fiscal year 1948, or 13.7 per cent of their total taxes. At the local level, the importance of income taxes is rapidly growing in certain communities.

It is well known that the determination of taxable income is often an arduous process, and that success demands the intelligent and hearty cooperation of the tax officials and the taxpayers. Of the modern taxes the income tax is often regarded as the most equitable, but also the most complicated. The services of accountants, economists, attorneys, and other tax experts, as well as of the courts, may be required to reach a reasonably satisfactory determination of taxable income. Moreover, because the tax rates are high and many millions of taxpayers are involved, the game of tax-dodging has become more popular, and in certain respects tax administration has become more difficult.

Evidence of the greater urgency of tax administration problems may be found in the continuing complaints of the taxpayers that income tax administration is encumbered with red tape; that the tax officials are frequently more interested in

collecting revenue than in determining taxable income accurately; that the taxpayers are too heavily burdened with responsibilities in justifying necessary deductions and other items affecting taxable income; that income tax administration is not uniform among taxpayers and areas; that the administrative personnel is inadequate in quality and sometimes in quantity; that initiative and investment are restricted by fears of arbitrary and unreasonable determinations of tax liabilities; and so on.

On the other hand, the tax administration charges many taxpayers with a failure to cooperate, with efforts at evading taxes, and with other practices that make tax administration more difficult. It is also said that insufficient funds are available for adequate income tax administration, and that despite the complaints of taxpayers the administration of income taxes has improved. Some of these charges and countercharges are no doubt the inevitable concomitants of employing income taxes, with their inherent complications. But it seems apparent that income tax administration can be improved in various respects, as suggested by recent studies, and the recent tendency of tax officials and taxpayers to come together and discuss their common problems.

The growing importance of income tax administration is further related to the emphasis in recent years upon fiscal policy as a regulator of the health of the economy. If the economic and social effects of income taxation are to be consistent with the nation's goal of more effective resource utilization, and a rising, more stable, and more equitably distributed national income, the income tax must be administered as fairly and effectively as possible, and it must not be asked to do things that are administratively impracticable. One can hardly become proficient in aviation without a knowledge of the airplane, and a nation cannot employ fiscal policy successfully unless it understands the practical problems of income tax administration and becomes familiar, by research, with the effects of income taxation upon consumption and investment and the well-being

of the economy. The statement that no tax, whether it be utilized for revenue or regulation or both, can be better than its administration is particularly applicable to the income tax, with its broad base and its numerous complications.

There has been a general tendency in the fiscal literature to emphasize issues of tax policy and to take for granted the requirements of tax administration. Perhaps this is inevitable when a subject involves many technicalities, as income tax administration does, but the basic principles of tax administration and the need for improved administration should be understandable to the general public. During the seventeenth and eighteenth centuries, in the transition to the dawn of modern fiscal systems, various writers spoke of the necessity of fair and efficient tax administration, as revealed by the essays of the Cameralists, the Mercantilists, the Physiocrats, and others. By 1766, Von Justi, sometimes called the greatest of the Cameralists, was emphasizing the fundamental importance of equity, certainty, convenience, and economy in tax administration, including tax compliance. Ten years later, in his classic statement of tax maxims, Adam Smith gave a greater vogue in tax literature to the principles of certainty, convenience, and economy, as well as equity, and showed an appreciation of the close relationship between tax policy and tax administration.

With the advent of the modern income tax, more thought has been given by students of government, economists, and others to the principles and problems of tax administration. But until recently, much more emphasis has been placed, in general, upon tax policy than upon tax administration. An illustration of this tendency may be found in John Stuart Mill's *Principles of Political Economy*. Here Adam Smith's maxims of taxation are quoted with approval and serve merely as an introduction to a discussion of how to attain justice in distributing tax burdens. The maxims of tax administration are assumed to be so self-evident that no further discussion of them is deemed necessary, and Mill departs for what is to him the more interesting discussion of tax policy. Administrative

problems are similarly neglected in most of the current discussions of economic principles and problems and fiscal policy.

Fortunately, in various tax conferences, in the studies of those interested in fiscal administration, and elsewhere in the literature of public finance, there is a widening awareness of the importance of tax administration. By force of circumstances—with the rise of public expenditures and the development of the income tax as a major revenue, as a result of lowered exemptions and increased rates—we are being compelled to devote more attention to the problems of income tax administration. There should evolve from the experience and studies of tax administrators, tax practitioners, economists, and taxpayers a better understanding and a clearer statement of the fundamental requirements of efficient and equitable tax administration. With continuing efforts on the part of all those interested, it should be possible to achieve a wider appreciation of the principles of tax administration and a much broader application of those principles in the tax system. Then our heavy and growing tax load may be distributed with the maximum equity, convenience, certainty, and economy.

In this conference it is hoped that certain of the important aspects of federal, state, and local income tax administration will be analyzed by those who are close to the situation, and that a number of constructive recommendations will be made. Here the tax official, the taxpayer, and the tax student may exchange views upon administrative problems and provide a sounding board for the education of a wider public on issues of vast significance to us all. One may find here striking evidence of the greater importance of, and the greater interest in, tax administration. For the first time in its history, the Tax Institute has devoted a comprehensive conference to the discussion of tax administration. In the past, tax administration has been studied only incidentally in the discussion of property, income, and other taxes. Now tax administration has come into its own as a major element of taxation, and while we are able here only to scratch the surface, it is to be hoped that in the

few days of discussion significant contributions will be made to the attainment of greater equity, convenience, certainty, courtesy, and economy in the administration of our income taxes.

As chairman, I am particularly grateful to the other members of the Program Committee who have contributed most helpfully to the arrangement of the program. They were:

Subcommittee on Federal Income Tax Administration
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George F. James, Standard-Vacuum Oil Company, and Chairman of U. S. A. Committee of International Fiscal Association

We are happy to have had the cooperation of the International Fiscal Association in arranging and conducting the session on International Aspects of Income Tax Administration.

The Committee on Local Arrangements, under the able leadership of Chairman Arch. W. Bowser of the American Petroleum Industries Committee of the American Petroleum Institute, made a substantial contribution to the success of the conference.

In conclusion, I wish to express the debt of gratitude that the Program Committee owes to all those participating in the conference as speakers and audience, to the members of the Tax Institute and its friends for their many helpful suggestions, and to our capable Executive Director, Mabel L. Walker.

Alfred G. Buehler
Chairman,
Program Committee

University of Pennsylvania
December, 1948

PREFACE

HERETOFORE income tax conferences and symposiums have generally been concerned primarily with matters of economic policy and substantive law. This is quite natural because these fundamentals constitute the basic grist for the mill of income taxation. This symposium is unique in that it is devoted entirely to income tax administration.

The decision to concentrate on administrative as distinct from policy or substantive tax problems may have been a bold one, but it was surely a wise one. For, as has often been said, no income tax law is really a good tax law unless its administration can also be said to be good. This is so because income taxation is a matter which singularly injects itself into the affairs of men; it touches nearly everyone; it must operate in a living world. Unless the administrative machinery is well designed and operated efficiently and in keeping with commonly acceptable notions, the law will not work well, however sound may be its abstract rules and underlying policy.

This means, among other things, that the governing rules must be reasonably clear and predictable so that those who are subject to them may plan their actions in the light of foreseeable burdens. It means that unreasonable retroactive application of new rules, having the practical effect of ex post facto laws historically so abhorrent to free peoples, should be avoided. And it means that the rules once adopted should be fairly, impartially, and efficiently enforced, with equal treatment to all in like circumstances, and with avoidance of unnecessary complications and disputes. These aspects of taxation are important in achieving equitable administration. Moreover, they are important in securing and maintaining taxpayer

cooperation which is so essential to a tax which is largely self-administered. Indeed, they are important to the promotion of national prosperity, since stability and orderliness in administration tend to inspire confidence and encourage production, while uncertainties have a retarding effect.

The symposium was designed to afford an opportunity to government officials, taxpayer representatives, and others interested in the subject to survey the administration of our income tax laws in the hope that out of the exchange of views might come helpful suggestions for improvement and a wider public understanding of the problems involved. Preceded by a discussion at the opening luncheon of the basic goals of tax administration, four sessions of the symposium were devoted to the federal income tax. The remaining three sessions were given over to state, local, and international income taxes, the session on the latter being conducted in conjunction with the International Fiscal Association.

It seemed fitting to open the subject of the federal income tax with a discussion of the divisions of governmental responsibility. Ours is a government of divided powers, legislative, executive, and judicial. All three branches have parts to play in our taxing system, and all share responsibility for sound tax administration. No one branch can alone do the whole job. Failure of one branch to exercise its proper responsibility, or overlapping action by any one branch, creates difficulties for the others and may adversely affect the over-all result. What are the responsibilities which should be met by Congress? By the executive departments? By the courts? What, for example, is the importance in income tax administration of the form of statutory draftsmanship, the timing of legislation, and the adequacy of financial appropriations? What about the existing division of authority between executive departments, and their respective policies as to interpretation, development, and application of substantive law? And, as to the courts, what is the effect of existing rules of statutory interpretation, of resort to legislative history and purpose, and of the judicial development

of a tax "common law"? Surprisingly little has been publicly said or written concerning what should be done in these areas to improve income tax administration, and the Tax Institute was fortunate in obtaining the contributions of distinguished leaders in the tax field who have long given thought to these most interesting and highly important topics.

The second session on federal income tax administration was devoted to the more personalized yet vitally important subject of Bureau-taxpayer relations. Highly qualified speakers dealt at this session with advocacy and objectivity in tax administration, and the relations between taxpayers and field agents, collectors' offices, and central administration, a dash of Canadian experience in decentralization being added for seasoning. The third session was concerned with specific administrative problems of current importance, namely, depreciation allowances, compensation problems, income and expense problems, enforcement of Section 102, and administration of the excess profits tax relief provisions. The fourth session consisted of a round-table discussion by a panel of experienced tax practitioners of a large number of administrative problems with which they have been confronted in day-to-day practice.

The three ensuing sessions on state, local, and international income tax administration included discussions of many important and troublesome problems in those fields by persons well qualified to deal with them.

It is too much to expect that definitive solutions can be provided at a symposium of this sort, or that concrete improvements in income tax administration will flow directly therefrom. But the effort will have been well worth while if it helps clarify the areas in which improvements are needed, and aids in the stimulation of a wider interest in problems of tax administration and a greater awareness of their importance.

As a member of the Program Committee and Chairman of its Subcommittee on Federal Income Tax Administration, I wish to take this opportunity to join in expressing the sincere appreciation of the Program Committee and of the Institute

to the distinguished participants in the symposium and to those who rendered yeoman service in arranging it.

NORRIS DARRELL
Chairman,
Subcommittee on Federal Income Tax Administration

New York
December, 1948

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PART ONE

BASIC GOALS OF TAX ADMINISTRATION

CHAPTER I

BASIC GOALS OF TAX ADMINISTRATION

LUTHER GULICK

President, Institute of Public Administration

THOUGH there were systematic tax ideas before Adam Smith, such as those of the Physiocrats, we will all agree that Adam Smith's *Wealth of Nations* in 1776 presented the first broad and influential statement of the goals of taxation. They were summarized in the following few and famous words:

> The tax which each individual is bound to pay, ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. . . .
>
> Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it. . . .
>
> Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury . . . though vexation is not, strictly speaking, expence, it is certainly equivalent to the expence at which every man would be willing to redeem himself from it.

THE CLASSICAL CANONS OF TAXATION

In addition to Adam Smith, intellectual history records three other men who have made an equally serious effort to define the goals of taxation systematically. They are Adolf Wagner, the German; Bastable, the Briton; and E. R. A. Seligman, the American. The following table shows the major tax goals recognized by these fiscal economists.

This table, like any single-word summarization, does violence to the ideas of the authors. The order of the criteria is as presented by the author only in the case of Adam Smith.

THE CANONS OF TAXATION

	Adam Smith (1776)	Adolf Wagner (1877)	Bastable (1892)	Seligman (1909)
Social, Economic, and Ethical	Equal on basis of abilities and revenues	General Proportional Appropriate Harmless to the economy	Just Proportional Harmonious Harmless	Universal Uniform Harmless
Fiscal		Adequate Elastic	Productive Elastic	Adequate Elastic
Administrative	Certain, not arbitrary Convenient to pay Economical in collection	Certain Convenient Economical	Certain Convenient Economical	Certain Convenient Economical Enforceable

The others have been made to conform for comparative purposes.

Many other fiscal philosophers have discussed various aspects of our topic.

One of the most famous and cynical rules of taxation is that attributed to Colbert, a hundred years before Adam Smith: "The Art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing." (1665)

An extremely important contribution to economic and tax theory was made by John Stuart Mill in 1848. He devoted special attention to the first line of our table, the problem of equality, justice, or uniformity. He found his answer in the idea that taxation involves sacrifice, and that a good tax system would therefore impose *equal sacrifices* on the taxpayers, where Smith had been satisfied to measure uniformity of tax burdens by the rule that they should be proportional to the income of the taxpayer. Pigou, in a brilliant analysis, came to the conclusion that the best tax system was one which so distributed the tax burden as to cause the *least aggregate sacrifice.* Sismondi, the Swiss, who came to the conclusion in 1836 that laissez-faire capitalism could not avoid bust-and-plenty because

the free market does not in fact tend to distribute purchasing power so as to result in the consumption of the product of a fully employed economy, urged that a good tax system would:

1. Tax revenue and not capital.
2. Tax net income and not the gross revenue.
3. Exempt the minimum subsistence required by the taxpayer.
4. Not put to flight the wealth it strikes.

This negative notion of harmlessness, which you find in all writers, is stressed by the British economist Robert Jones (1914) in his rule that taxes should be collected:

1. Without checking production.
2. Without waste.
3. Without stirring up opposition.
4. Without creating social and economic evils.

T. S. Adams, in a review of the famous New York Tax Report of 1932,[1] said that in his rule book there were two cardinal virtues of a tax system that came ahead of justice and equality. These he termed as "temperance" and "certainty." "In my opinion," added Adams in italics, "the primary task of the legislature in making and revising taxes is to readjust taxes in accordance with the rising and falling fortunes of various industries and social activities." [2]

I am getting ahead of my story. Let us turn back to the canons for a moment. You will note that I have split the table into three broad bands. The top band includes the social, economic, and ethical considerations; the second band includes the fiscal considerations; and the third band includes the administrative considerations.

In each of these broad areas or bands, there has been important advance in thinking and experience over the years covered by this table. I want to review this development briefly to show where we have come out in 1948, and to lay the basis for five important conclusions.

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[1] New York State Commission for the Revision of the Tax Laws, Seabury C. Mastick, Chairman, Robert Murray Haig, Director of Research, *Report.* Albany: Legislative Document (1932), No. 77.

[2] *Bulletin of National Tax Association,* XIX (October, 1933), 4.

Social, Economic, and Ethical Considerations

Equality

The idea of justice and equality has been subjected to extended development. The most satisfactory general analysis to date is that of E. R. A. Seligman. He took the position that the first two canons of taxation are "universality" and "uniformity." Under "universality" he would demand that taxes be not levied specifically on named individuals or on narrow and special classes, but that they should be extended to the entire normal population in the broadest possible categories and groups. All tax experts agreed with this principle, with variations as to tax exemptions.

It is in defining "uniformity" in taxes and showing how to reach such uniformity that Seligman made his greatest contribution. This he did first by excluding all special rates, fees, assessments, and taxes levied to pay for measurable or recognizable benefits from his definition of taxes. This left him solely with the general taxes levied for the general support of government. These he said should then be distributed in accordance with the "faculty" of the several taxpayers. Parenthetically it should be added that there is nonetheless a lot of revenue and a lot of administration involved in the rates, fees, and assessments, and many problems of equity as well. By this keen and sound analysis, however, Seligman threw over the benefit approach and the sacrifice approach in discussing general taxes. He then went on to define "faculty" by applying the classical doctrine of marginal economics both to consumption and to production. Thus he built into his doctrine of equality the marginal utility theory for both consumption sacrifice and the ability to produce income.

This gave the first firm theoretical basis for progressive taxation. As a result Seligman did as much as any one man to make the theory of progressive taxation acceptable around the world. Political forces did the rest. As Robert M. Haig has said: "The

popularity of progressive taxation in recent years is doubtless traceable in no small part to the opportunity it offers in a democratic state to place added burdens upon the group which, while economically strong, is often politically weak." [3]

Though the "free market" and marginal economics on which Seligman rested have taken a beating at the hands of Marshall, Chamberlain, Mills, Means, Berle, and others, the thinking man around the world, even the man of large income in a capitalist society, accepts the notion that steeply progressive taxation is fair and equitable. This was not true fifty years ago.

It should be pointed out, however, that the theoreticians have never given us any practical help in determining how steep the curve of progression should be, or how far it should rise to maintain "uniformity" in relation to "faculty." This has been left to practical politics and fiscal experimentation.

I have often wondered why this problem might not be approached by a study of the savings function. If we intend to maintain private capitalism, and to increase our supply of tools and technology continuously, we need to make certain that we do not, through taxes, inadvertently destroy the possibility to save or the incentive to invest. In a recent study of taxes in a southern state we found that the cumulative burden of federal, state, and local taxes in 1948 destroys all probability of saving at the very bottom of the income scale, and also in the upper reaches from about $30,000 a year and up. I am convinced that a careful study of family budgets from $5,000 a year and up in relation to individual and total savings and investments would throw some very revealing light on the practical and theoretical limits of progressive taxation. In a continuing capitalist society, society must have an interest in individual savings. Such savings are just as important as mass spending as an energizer of the economy.

[3] *Encyclopedia of the Social Sciences*, XIV, 539.

Harmlessness

I am not going to say anything about "harmlessness" as a scientific and definable canon of taxation or of the extent to which "an old tax is a good tax." This is the barn door through which the fiscal scientist brings in his pet horse. It is much better to be frank about such things, however, than to try to sneak them under the tent when no one is looking. And in fairness to the economists cited, it must be said that each man has developed a complete, logical, and tightly reasoned economic structure which he insists the tax system must not harm. Each economist's theory of tax incidence, for example, grows directly out of his concept of the economic system, not vice versa. The mention of harmlessness among the canons is therefore primarily a forceful reminder that the tax system is an inseparable part of the economy, and that no one can consider the goals of taxation apart from his concept of the nature of the social, economic, and political order.

Fiscal Considerations

Adequacy

The canon of "adequacy," next on our list, has all but gone into eclipse at the national level. The abandonment of the gold standard took care of that, with the aid of the American Bank Note Company. But at the lower levels of government, the problem of adequacy of revenue is becoming extremely acute, partly because of the pains caused by the inflation brought on by national fiscal mismanagement. Thus, while deficit spending by the national units may have appeared to solve their revenue problems, such spending has come home to roost in local government revenue shortages so pressing in character as to threaten the survival of local self-government, and has at the same time wreaked havoc in the private sector of the economy. Thus the problem of adequacy, which once was a problem of gold, has been transmuted into the more difficult, though more

flexible, problems of fiscal policy, money, and inflation. Such is the alchemy of managed economics.

Elasticity

Important new thinking has been given to "elasticity," particularly since 1930 and the general advocacy of cyclical rather than annual budget balancing. The partial acceptance of the Keynesian analysis, with its thesis that taxes should not restrain mass expenditures during depressions, should skim off the unspendable income during periods of war, and should cut the peaks of expansion sprees, has greatly spurred this type of fiscal policy. The "inflationary gap" we have heard so much about is the gap between expenditures and taxes, and could always be closed by flexing the taxes upward. Gunnar Myrdal, the Swedish economist and statesman, though a firm believer in cyclical budget balancing and in adjusting taxes up and down as a counter-balancing factor to the business cycle, pointed out in 1939 [4] that deficit financing in the depression so frightened business interests as to restrict or reverse the planned inflationary effects of the deficit program. H. G. Moulton has driven this point home more than once. Myrdal also admits that the downward revision of taxes in time of depression, in accordance with the "pure" anti-deflation theory of Abba Lerner, Hansen, and others, has been all but impossible of application in any country because of the insistent demand in time of depression for more revenue to finance more public activities to make more jobs. Thus, though we have had a great deal of new theory on the use of flexibility in taxation for fundamental economic purposes, we failed to try the dosage in the great depression. This is less true of the war years. In all countries, during the war, taxes were flexed upward in part to sop up excess spending power. The Canadian program in which budget policy, tax policy, price policy, rationing policy, and import-export policy were geared together with great success is a case in point.

4 "Fiscal Policy in the Business Cycle," *American Economic Review*, Supplement, XXIX (March, 1939), 183-93.

In this connection two other developments deserve mention. The first is the shifting of the United States national income tax to a current collection basis. This plan was put forward by Beardsley Ruml primarily to translate the income tax to a current basis so that it could be used when required as an immediate stimulating or restricting force on disposable income. It is ironical that the first change in the rate should have been downward by the Republicans (our traditional sound money party) in the midst of a serious inflationary situation and coincident with a marked expansion of military expenditures.

The second development was the establishment by many states and cities of improvement reserve funds instead of reducing taxes during the war, and the establishment of genuine tax stabilization funds in New York State, California, and Rhode Island since the war. These reserve funds represent taxes collected beyond current needs and impounded to meet requirements which will arise in the future if a recession is encountered. These tax policies have been accepted by the public because they believe that high taxes now are to be preferred to tax increases in the event of a depression. This is an important development of public tax theory and practice.

Tax elasticity was originally discussed by the experts primarily in terms of budget balancing to meet treasury needs. That is not the situation today. The transition of thought to dynamic taxation has been painful, however. Many of the classical fiscal experts were so shocked to discover that taxes were being used to change the distribution of wealth intentionally and not accidentally, that they entered into violent debates as to whether it was ethical or "sound" to plan the tax system to have any effect on the economy—except of course in connection with the consumption of liquor, the manufacture of butter substitutes, the issuance of bank notes by state banks, and the importation of manufactured commodities. For them, all taxation was to be "for revenue only;" any desire to push the economy one way or the other with taxes was strictly taboo.

The situation is certainly different today. Whatever the

views of economists and fiscal planners today, from Colm to Schmidt, from Ruml to Lutz, or from Hansen to Hayek, every man agrees that taxes not only affect the economy profoundly, but that the effects desired are inevitably a primary consideration in the development of the tax system. This represents a dramatic new development in fiscal science. Every tax expert is now an economic planner, however much he is personally opposed to economic planning. Some boast of planning through taxes, others decry it; but all are planners and can't help it.

Administrative Considerations

This brings me to the last band of tax goals, the administrative canons. You will note that the list has remained unchanged for 170 years except that Seligman, in one of his essays, makes so important the idea that practical enforceability is more significant than theoretical perfection that I have added this to his canons, though he did not do so himself. But the significance of the words "certain, convenient, and economical" has shifted over the decades, primarily because of the advance of responsible government and the dramatic expansion of the proportion of income taken by taxes, both because of the extension of governmental services and because of the tremendous cost of modern war. When Adam Smith said that taxes should be certain and not arbitrary, he was thinking of arbitrary individual exactions imposed under the corrupt French court which soon helped to bring on the French Revolution. When we use these words now we think of (1) limited class legislation, (2) unknown and unreviewable Treasury decisions, and (3) personal arrangements by assessors, particularly in the enforcement of the general property tax.

The Threat to the Property Tax

I want to say a special word about this, because I am convinced that the major area of arbitrary taxation in the United States today is found right in the local assessment rolls. Why do

we have this mountain of injustice at the very foundation of our tax system? For two reasons: *first,* because the general property tax law where it includes land, buildings, furniture, machinery, merchandise is hopelessly out of date; *second,* because we hire the wrong kind of personnel to do the assessing. In most jurisdictions assessors are still elected for political reasons, not appointed for their technical qualifications.

The general property tax, in most states, is 50 to 100 years out of date in comparison with economic developments. The general property tax was a good tax in primitive rural conditions, but it is an unfair and therefore unenforceable tax in present-day urban and industrial society. With current high tax rates—and these are necessary and desirable in the cities—the property tax cannot be applied to intangible wealth, to personal property, or to manufacturers' and merchants' stocks and equipment. Nor can the tax ignore the fact that most city dwellers are renters today. What does the assessor do under the circumstances when the legislature fails to amend the law to keep it up to date? The assessor amends the law himself through nullification and individual personal arrangements. This is not a government of laws; it is a government of men. And the fault is not that of the assessor; it is the fault of the lawmakers.

In the process, the property tax on real estate, which can and should be the mainstay of local taxation and the great bulwark and balance wheel of local self-government, is in danger of disintegration, so that the local governments will be thrown more and more on the mercy of state and federal handouts, and the inevitable gradual loss of administrative and governmental independence. How can we save the property tax? By modernizing and purifying the tax, by making it economically enforceable, and then enforcing it vigorously with technically competent assessors. Unless the property tax is thus squared with the canons of certainty, equity, and harmlessness, to use the words of our table, the property tax itself will become dis-

credited, with all that this will involve in the inevitable constriction of local self-government.

Relation of Administration to Other Canons

What I have just said about the injustice of the general property tax, partly because of its weak enforcement, can be said of all other taxes. Without efficient, certain, even-handed, open, and vigorous administration of income taxes, inheritance taxes, corporation taxes, liquor and gasoline taxes, and import tariffs, for example, there is no such thing as universality or uniformity of taxes. The same is true of the canons of "harmlessness," "adequacy," and "elasticity." Every one of the goals of taxation listed in the top two bands of our table is unrealizable without the fulfillment of the administrative goals, and is conditioned by the available techniques of enforcement.

Any one who reviews the goals of taxation in this decade would be justified therefore in expanding Seligman's last canon "enforceable," and in insisting that few problems in tax theory are so important today as the actual administration. Many a fine tax theory will continue to be a mirage until and unless we can embody the tax theory in appropriate laws, rules and regulations, administrative structure, trained personnel, and the consonant pattern of official and taxpayer behavior. The purpose of taxation is not its administration, though some bureaucrats seem to think so; but without the administration, none of the purposes of taxation can be achieved. Thus we stand at a period in fiscal history when attention to the administrative requirements is of prime importance.

A New Canon: Political Conformity

I suppose every one who thinks about the goals of taxation and reviews the classical canons as we have today is entitled to shoot a few cap pistols himself. Each generation must after all make its own emphasis. Thus viewed, on the basis of the needs of our time, I would add one important tax goal which is inadequately dealt with in the classical canons. This I shall call

"conformity with accepted political principles." It goes in the first band. I can give you the idea in a few words, because you will recognize the soundness of the concept as soon as I state it.

Under modern conditions taxation is not solely an economic fact, as most economists have seemed to think. It is equally a political force. In this country, this fact has tremendous importance in two prime areas. The first has to do with our structure of federalism and home rule, and the second with the nature of the democratic process.

In the federal system, we are deeply concerned with maintaining independent states which are free to operate within their appropriate social and economic spheres. We must be alert to resist developments which contain hidden tendencies toward the extinguishment of the legitimate individual state life, and thus threaten the impairment or destruction of the federal system. The same problem arises in the maintenance of municipal home rule.

Neither home rule in cities nor state sovereignty can long be maintained if the city or the state becomes dependent upon the annual budget action of a superior governmental unit. A tax system which makes such dependence inevitable is inadvertently beginning the disintegration of home rule as to local governments, and the federal system as to the states.

Historically, not a few federal systems have grown into unitary national states partly because of the effect of a tax system which was not in conformity with the federal principles of its political structure. This end of federalism might not have occurred in these areas if the tax system had been designed in conformity with the political principles of the particular federal system.

The second area of conformity called for in this country is conformity of the tax system with the principles of self-government. In self-government we depend upon the voters to decide, both directly and indirectly, what governmental services and controls they want and how much they are willing to pay for those services. The voters decide how much of their in-

comes they wish to spend themselves as individuals, and how much they wish to turn over to their government to spend for them for things which they feel can better be done by organized community action. What happens to this balancing of comparative values by the voter, if the voter discovers that he pays very little or nothing toward the cost of the desired service? What happens to the prudential motive if the voter finds that some rich uncle—like Uncle Sam—will foot the bill, and that the burden falls on so distant and so undefined an economy, that there is no benefit to the voter from voting for careful governmental management in his home town, schools, city, county, or state?

The same problem arises with narrow-based class taxation, because once again, all the voters decide on the expenditure program, but only a small part of the voters are called on to pay the bill. Under such conditions how can the voter balance his needs and desires over against his costs, if he pays no costs? Unless the tax system is tailored to fit the dynamics of the political system, we may expect the political and economic system to shift its base.

I hope you will not misinterpret me. I do not feel that sound economic principles are opposed to progressive taxation, the exemption of basic living costs under the income or estate tax, or the limited use of federal and state aid in connection with programs of state-wide or nation-wide concern. Under a federal system of government, intergovernmental tax payments are inevitable because the structure of the economy does not coincide with the political boundaries of subordinate units, and because the functions of government cannot be neatly laid out in layers like a layer cake, but are apportioned on a cooperating basis of joint programming. But I *am* saying that the vitality of the prudential motive on the part of voters requires an extensive distribution of the tax burden to all voters in direct, visible, inescapable, and elastic terms. Unless the great mass of the voters pay more taxes when they vote for more governmental services, and know that they so pay, the demo-

cratic system cannot function as a system of democratically balanced decisions. If this be true, then it must be a goal of American taxation to make certain that the tax system conforms with our principle of democratic self-government.

CONCLUSIONS

What general conclusions may we draw from a reconsideration of the goals of taxation? To me the following points stand out:

1. Though any statement of tax goals is conditioned by the time and place of their formulation, there has been built up over the generations by great thinkers a remarkably consistent and helpful check list of tax canons. While it is not difficult to show that these goals are indefinite and, perhaps, internally conflicting, it must be remembered that this is true of all normative social standards. Those who ask for specific measurable economic and statistical rules of tax equity, or adequacy, or harmlessness, are not only looking for something which does not exist, but are thereby betraying the shallowness of their own analysis of social values.

2. Any comprehensive listing of tax goals cannot stand by itself; it is the tax part of the author's general scheme for society. As such, it is inextricably interrelated with the social, economic, and political institutions, and with the author's own total scale of values. Thus no man in his right mind should agree to talk about the goals of taxation at a meeting like this and thus stand intellectually and philosophically naked before his fellow man! The one comforting thought is that every one else who says "this tax is good" or "that tax practice is bad" stands similarly exposed in this well-populated philosophical nudist camp. Many who think they are well clothed are actually wrapped in cellophane. In every statement they make on taxes, you can see right through not only to their social, economic, and political skin, but to their philosophical skeleton—if any. From this we may conclude that it is unwise to hazard final and eternal principles in taxation without considerable

thought on the underlying social, economic, and political institutions and values of which taxation is but one phase. The only reason we rush in where philosophers should hesitate to tread is that administrators and politicians have to act. We know that the world cannot get on without us, but we pray for mercy on our naked souls.

3. The goals of taxation are interrelated and interdependent. No one of the criteria can be pushed to its limits without contradicting most of the others, nor can any one goal be achieved except in terms of all the rest. From this it follows that no tax stands alone, especially in a federal system, and that no tax system can or should meet the rigorous test of criticism by any one canon. The only appropriate test is composite and evolutionary.

4. During the past generation, as a result of the depression and the heavy costs of war, taxes have not only come to absorb a far larger share of the national income, but have come to be used consciously as dynamic elements in social and economic direction. The appropriate principles and techniques for achieving and regulating this flexible and dynamic use of taxation have not as yet been brought to their first stages of reasonable development in this country.

5. At this point in our history there are two further tax principles which need stressing, one an old canon, and the other a new goal.

The old canon takes us straight back to Adam Smith. We desperately need to re-examine and reform our total tax system in all its parts to make certain that it is certain, convenient, economic, and enforceable. Unless we do so, all our other goals will be but partially attained.

Second, we need to define, study scientifically, and enforce a new tax goal, born of our generation and of our democratic system with a federal government and municipal home rule. That goal is tax conformity with our political institutions, so that taxation will contribute to, rather than thwart, the balanced operation of our democracy.

PART TWO

FEDERAL INCOME TAX ADMINISTRATION: DIVISIONS OF GOVERNMENTAL RESPONSIBILITY

CHAPTER II

RESPONSIBILITIES WHICH SHOULD BE MET BY CONGRESS

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IT WOULD BE fine if federal revenue acts could be gradually so perfected that rate changes would be the only amendments which are needed from time to time. There is no sound hope of this, however, because of constantly changing conditions, and because of gaps, weaknesses, or special hardships discovered from time to time in the law. Therefore, even though a new Congress starts with an established tax system which has well served the country's requirements, a great variety of tax problems will need almost continuous attention. This paper deals first with five ancillary duties of Congress in this connection and later with its main duty, that of deciding what the actual text of the tax law shall be.

MAINTAINING PROPER RELATION BETWEEN APPROPRIATIONS AND RESOURCES

First, Congress must steadily keep in mind that the amount of government money which Congress can appropriate each year is, so far as all experience indicates, limited to what it can raise by feasible taxation and feasible borrowing.

Taxing and borrowing are the ways the government now uses of getting substantial funds, and borrowing can never be extended to a point such that taxing is unnecessary. Certainly, also, there are limits to feasible taxing, and a policy of overtaxing would bring serious results, not merely in failing to

raise the expected amount, but in a general breakdown, hurtful in the future as well as in the present, of the taxing morale which is indispensable to a working tax system.

Keeping the Public Informed as to Tax Matters

Second, it is an important duty of Congress and of its appropriate committees to make sure that the public is kept well informed on tax matters so that suitable taxation plans made in Congress will be understood and supported by the voters.

Any employee or agent who has knowledge which his principal needs and fails to disclose it, is a poor agent, no matter how obedient an agent he may be. So, also, an elected representative to Congress is a poor public servant if he fails to carry back effectively to constituents a fair share of the information and insight they need as voters. This is peculiarly true as to considerations affecting revenue legislation. Taxation is a highly complicated field in which popular prejudice easily leads to bad tax laws, unless prejudice is softened by up-to-date knowledge of the actual problems to be met.

Keeping Away from Partisan Politics

A third duty of Congress is to keep revenue legislation out of partisan politics as far as possible.

As Hamilton said in the *Federalist,* "A nation can not long exist without revenues." Like problems of foreign relations in a time of crisis, a country's revenue problems in a time of heavy spending are so desperately important and so difficult to solve wisely that they cannot be safely treated like the issues which do not involve revenue.

Although there have been some exceptions, it is in general true that the most astute politicians in our history have acted on the principle that playing politics with taxation is not only injurious to the country, but dangerous to the political future of the party which indulges in it. It is true enough that there are certain constituencies in the country which can be won over by promising tax legislation of a type which does not seem

to be a burden on those particular neighborhoods; nevertheless, there are not enough of such constituencies to make it good political tactics, generally, to mix partisan politics and taxation.

Making Appropriations for Collecting the Revenue

Fourth, Congress has the duty of making adequate appropriations for collecting the revenue.

The process of collection includes the task of discovering unreported tax liabilities, of applying the taxing act to specific states of fact presented by the affairs of vast numbers of taxpayers, and of negotiating settlements as to disputed tax liability. Of all the government's expenditures, the most fundamentally important are those for collecting the revenue, because there can be no billions for defense, or for social purposes, or for any other purposes, unless the taxes are continuously collected as laid. Nor can collection of high-rate taxes be achieved without well-directed and highly organized effort on the government's part.

The appropriations for collecting the revenue must be sufficient so that able key men at the top level can be induced to remain in service—likewise the very large number of experienced auditors, conferees, and lawyers necessary to deal expertly with millions of taxpayers. Responsible Bureau officers testified last spring before appropriations committees that, for each dollar then appropriated for investigating personnel, twenty dollars could be recovered in tax deficiencies. These statements were, as I believe, soundly based, and when Congress cut twenty million dollars from the budget estimate, it failed in this phase of its responsibility. Instead of *saving* twenty million dollars, Congress was, in my judgment, depriving the government of several hundred million in undiscovered back taxes.

Obtaining Information as to the Working of the Tax Laws

A fifth duty of Congress is that of keeping itself constantly advised as to the working of all the federal tax laws currently in existence.

Questions constantly needing attention include:

1. What sums are actually being produced by each of the kinds of taxes currently in effect?
2. To what extent are existing laws self-executing, in the sense that taxpayers voluntarily make payments as contemplated by the law?
3. Where such voluntary compliance does not occur, how successful is the administrative branch in discovering the noncompliance?
4. In situations where the administration discovers noncompliance, whether unintentional or otherwise, is the administration itself able to bring most of the resulting controversies to final conclusion, or do too many of the controversies get into the courts?
5. What is the state of public opinion, particularly among taxpayers, about existing revenue laws?

We American people from the beginning have been sensitive to the fact that governments sometimes make oppressive use of the power of taxation. We have consequently been insistent that tax laws shall directly reflect the will of the people, rather than the will of some government group, or even the technical judgment of experts. Because of this and of the further fact that a taxation system can be successfully productive only when most of the money comes in automatically without any long-drawn-out contest, the last of the questions just listed—the one about public opinion—is involved in the successful solution of all the others. We must depend largely for the future success of our revenue system on the continuance of the admirable tax-complying habit of our people. This can be maintained only by so drafting and so enforcing the tax laws as to deserve the respect of those who are taxed.

Examples of useful procedures by which Congress has informed itself as to such questions are found in the continuous activities of the staff of the Joint Committee on Internal Rev-

enue Taxation, the hearings held in 1946 as to the working of the relief provisions of the excess profits tax law, and, further, the appointment in 1947 by the Joint Committee on Internal Revenue Taxation of a group of experts to study the enforcement activities of the Bureau of Internal Revenue and to report back to the Joint Committee.

Deciding What the Actual Text Shall Be

Sixth and last, Congress is responsible for the actual text of the taxing statutes. This text has its adjective and its substantive parts.

Adjective Parts of the Text

The adjective parts of the text of the taxing act deal mainly with administrative procedures for determining, settling, and enforcing the liability of each taxpayer, and with the general administrative structure within which this work is done.

Certainly Congress cannot and should not try to *administer* the taxes it imposes, but its duty to legislate regarding many matters affecting administration is important. It is also true that when called on for "advice and consent" as to the competence of any nominee for an office in the taxation setup, the Senate would fail in its duty if it did not exercise its independent judgment.

In this connection there rests on Congress at this time, as I believe, a heavy responsibility to promote the career principle. Cooperation by taxpayers is vital, and taxpayers are far more willing to cooperate with a tax administration in which appointments are not tied up with politics. As matters are now, certain higher officials—such as the Commissioner of Internal Revenue and the Chief Counsel of the Bureau of Internal Revenue—are in danger of replacement whenever there is a new President or a new Secretary of the Treasury. This state of affairs, in which political patronage sometimes plays too large a part, needs re-examination. In defending the present system it is sometimes said that the "policy-making" officials should

be in close touch with the policies of the President and should therefore be a part of his administration. It is true that the administration in power is responsible for the general attitude of the Bureau of Internal Revenue in dealing with taxpayers, and, being so responsible, should have a hand in what goes on. On the other hand, the "policy" of a taxing act as regards the amount of money to be paid by each taxpayer is to be found in the taxing act itself, and it is the duty of executive officials, including even the President, to follow whatever policy Congress has laid down, and to see that it is followed.

Substantive Parts of the Text

We come now to the substantive parts of the text, specifying what kinds of taxes are imposed, and how to compute the liability of each taxpayer.

Some of the duties included in this textual responsibility are the following:

1. *Readjustments.* To make readjustments from time to time of the most fundamental parts of the tax-levying structure—those on which the substantial productivity of the act depends.

Such readjustments are constantly needed to fit changing public sentiment and to fit economic conditions as they go up or go down. A taxing act which is highly productive in normal times may produce pitiful amounts in a depression and may even aggravate the depression; at such times income taxes, for instance, may need to be supplemented by taxes which do not depend on income.

2. *Clarifying the existing provisions.* To recast existing statutory provisions which, although the technical effect is sound, are so artificially expressed as to be hard to understand.

Many of our present tax provisions are so ingeniously phrased that drafting experts greatly admire them, but by reason of the very ingenuities—particularly overcompactness—they are as baffling to the reader as most puzzles are. Taxing laws that are hard reading encourage fraud and evasion. Vicious

tax evaders of such provisions may have reason to feel that they are relatively safe from conviction, because if they are tried before a jury, the jury, on hearing provisions of the tax law read, is easily persuaded that the accused merely did not understand.

Drafting a statute to suit the special skill and intelligence of judges or experts does not solve the drafting problem; the text of the law should be such that examining field agents can understand it. In a really successful revenue system, recourse to the courts should occur as to only a minute proportion of the total possible points of difficulty. The settlement of tax cases must in the main be an administrative process, and settlements avoiding litigation are in accord with the best interest not only of the government, but of the average taxpayer. If, as they should be, such settlements are to be made by government agents in the field, it is good sense to phrase the taxing act so that field agents will not find it unnecessarily confusing. For the same reason it is also good sense to see that so far as possible the will of Congress is to be found in the act itself, without recourse to reports of court decisions.

While important improvement can be made in the language of the Code, there can be no such thing as a sound taxing act, at high rates, which the man in the street can readily understand. This may be unacceptable news to some who have been demanding such a tax law, but it is true. The range of transactions and situations to which the tax laws must be adapted is immense. A really simple tax law would leave unanswered thousands of questions sure to arise in applying it, and would be without the reliefs and exceptions which any high-rate tax law must provide if it is to avoid destructive injustice in the case of a considerable number of taxpayers.

While improving the form of the existing Code, Congress would do well at the same time to eliminate certain provisions which tend to complicate it without any corresponding degree of benefit to the whole system. Examples include the over-theoretical provision which requires that, to be taxable, ordi-

nary corporate dividends must be out of earnings accumulated since March 1, 1913; also certain other overcomplicated provisions involving that date in relation to depreciation and losses.

3. Carrying full legislative load. To carry the full legislative load, instead of intentionally shifting important parts of it to other branches of the government.

When a taxpayer finds that he is subject to an increased dollar amount of tax liability, his concern is that he must pay more tax, rather than as to whether the increase came from an increased rate, or from new rules governing deductions, or from new rules as to the nonrecognizing provisions, or from a change in some other rule for the computation of the tax. However caused, any change in the rules tending to make the taxpayer pay more money constitutes a levy.

From time to time the suggestion is made that many of the tax rules which determine how much each taxpayer is to pay ought to be established not by Congress, but by officials like the Secretary of the Treasury or the Commissioner of Internal Revenue, or by the concurrence of the two. This suggestion favoring legislative regulations goes far beyond the ordinary interpretative type of regulations to which we are accustomed, and for which we must continue to depend on the administrative branch. It is based on the theory that the administrative officers from their varied experience should know more about all of these matters than Congress is able to know, or even to find out.

The difficulty with confiding substantial portions of the taxing power to executive officials is not merely that the people have never authorized executive officials to go further than to collect taxes as laid by Congress and to make recommendations to Congress. The main difficulty lies rather in the Treasury's inability, by reason of its special function as taxgatherer and protector of the revenues, to hold an even balance between the interests of the taxpayers and its own interests as the government's agency for getting money. The Treasury is inevitably

biased in favor of the government, and this is frequently illustrated by the way in which tax regulations reach far to the edge of each twilight zone and often beyond. In litigated cases the government readily admits its partisanship; it justifies its taking of inconsistent positions in such cases, depending on how the dollar advantage to the government falls in each case, by explaining that it is forced to do so because the government's interest would otherwise suffer.

If suggestions that Treasury officials be given increased regulation-making power are refused, the country loses nothing substantial, because Congress and its agencies, by conferring with Treasury officials, can get the benefit from time to time of all the Treasury's experience and study, in addition to information derived from public hearings and from study by experts employed by Congress.

At times, also, Congress itself has seemed to lean toward another and quite different idea, under which many questions of tax detail are purposely left open by Congress, relying on the judicial branch to fill the gaps thus left in cases which may at length come up in court. For a number of reasons, which space does not permit to be stated here, my own view is that it is best for the courts not to give legislative service in the tax field to any extent beyond what is absolutely necessary—meaning by "absolutely necessary" the occasional instances in which a litigated case presents facts so different from what Congress had in mind in enacting details of the taxing act that there is nothing in the act bearing on the question one way or the other, except words from which an intention to tax the situation might be inferred. It should be added, however, that the courts have not adhered, so far, to the relatively narrow policy here suggested as desirable.

For the reasons above given, I am convinced that Congress should make its own sufficiently ample investigation in respect to any known gap in the taxing act, and then itself specify what the law is to be.

The staff of the Joint Committee on Internal Revenue Taxa-

tion is an agency now available not only to keep in touch with every possible source of information, but to assist in appropriate phrasing of new provisions. Furthermore, one of the expert draftsmen who are now employed by Congress could well be assigned to work constantly with the staff and with the Joint Committee during all stages of study, so that he would, in effect, grow up with each provision as it develops.

The undue prominence which has been given by newspapers to the doings of irresponsibles in Congress must not blind us to the fact that Congress, although it has made its share of mistakes and will make mistakes in the future, can be counted on to do better work in its own part of the taxation system—especially its task of prescribing, in language appropriate to a taxing act, the rules by which tax liability is fixed and computed—than could be done in this rule-prescribing field by either the executive branch or the judicial branch.

To illustrate, Congress enacted certain nonrecognizing provisions in the income tax law, using the word "property" in them. Disputes reached the courts as to whether cash received in an exchange is to be treated under these provisions as "property" so received. The Bureau of Internal Revenue delayed action in a considerable number of cases until the intention of Congress in this respect could be discovered. Legislative responsibility for the making of a general rule on this point lay with Congress and nowhere else; Congress could have settled the point one way or another in much less time than the courts take. Instead of amending the law to settle the point, Congress did nothing, and there was a delay of several years while an answer to the question gradually emerged from the courts. Congress was in the indefensible position of waiting for the courts to tell it what its own intention had been. The government was the loser not only by reason of the long delay, but by reason of the fact that the decision when it came was a provision drafted by an authority not so well qualified as Congress is.

In contrast with what has been said about the broad rule-

making duty of Congress, it is unwise and inappropriate for Congress or any other authority to lay down specific rules as to certain types of determinations affecting tax computation. Thus, in the determination of depreciation allowances and of fair market values and of reasonable allowances for salaries, the Commissioner and his assistants should apply sound judgment to the specific facts of each case, unfettered by specific rules. Congress—or the Treasury—would do harm and not good in laying down rules in any of the matters which must depend on the use of judgment in relation to each special fact-situation.

Likewise, specific rules cannot usefully be provided with respect to the amount of relief to be given from the excess profits tax, under the relief provisions which involve the Commissioner's determination of a "fair and just" constructive average base period net income; the presence of relief provisions of this type in the law stems from the fact that no rule or formula could be found to do justice in the abnormal cases. To determine a "fair and just" figure the determiner must have freedom to arrive at a fair and just result. The distinction between the type of question as to which rules can be prescribed and the type in which they should not be prescribed lies in the fact that it is impossible in some situations to reach a fair result by applying a fixed rule. These are the issues which can only be fairly determined by the use of judgment. Judgment hemmed in by rule ceases to operate as judgment; rule-making therefore must be dispensed with as to such issues.

4. Putting judge-made items of tax law into the statute. To scrutinize judge-made items of tax laws which have become a settled addition to the law of taxation, and either incorporate them in the taxing act at the proper place or recast the statute so as to disaffirm them.

The action of Congress may merely involve, where the judge-made law coincides with what Congress considers the law should be, translating what the courts have said, or have decided in specific cases, into proper statutory language, showing precisely what parts of the taxing act are being changed. On

the other hand, Congressional action may involve nullifying the judge-made items of tax law where that course seems advisable. I cannot say this as yet represents any general existing policy of Congress. Such a policy, however, seems necessary, in order to put as much of the applicable tax law as possible in one place—a carefully organized tax statute. To carry out such a policy, Congress already has, in the staff of the Joint Committee on Internal Revenue Taxation, an agency which could give it continuous help along these lines.

5. Making tax results more predictable. To attain the greatest possible degree of precision in the tax laws, so that a well-advised taxpayer contemplating a transaction can know in advance what the tax effects will be.

Uncertainty as to whether a transaction is likely to produce a heavy tax often prevents the transaction from going through at all. At present our taxing system involves far too much uncertainty of this kind. One cause of that uncertainty, in my judgment, is the extent to which courts at present are inclined to go in making tax law, with retroactive effect and along lines which cannot be quite predicted. Further, although the strictly interpretative work of the courts in the tax field is excellent, many so-called "test cases" in which the courts—including the Supreme Court—have ventured on *legislative* tasks have tended to cause further uncertainty and litigation instead of putting an end to them.

The current inclination of the courts in the direction of making tax law in addition to merely interpreting it certainly does not relieve Congress from its own clear duty of making the taxing acts explicit.

One frequently advanced argument is that if the taxing act is left vague and the courts encouraged to make tax laws as well as interpret them, the courts are left effectively free to defeat schemes devised by taxpayers skilled in taking advantage of loopholes. The answer to this argument seems to be not only that such action goes beyond the proper function of the courts in taxation, but that, once Congress is advised of a loophole,

it can close the loophole more precisely and more promptly than a court can. It is true that Congress in enacting a loophole-closing provision must remember that, as compared with the total yield of our revenue laws, the amount involved in loophole-closing problems is relatively not large, and also that Congress must take pains, in closing a loophole, not to injure well-disposed taxpayers by making loophole-closing provisions more drastic than necessary. Nevertheless, the courts, if they undertake the legislative task of loophole-closing, must face these same difficulties and are not so well equipped to deal with them.

6. Avoiding nonrevenue provisions which impair the revenues. To make sure that, whenever provisions are adopted in the taxing act mainly for nonrevenue purposes, these uses of the taxing power are such as will not seriously interfere with the effectiveness of the taxing act as a producer of revenue.

In our existing Internal Revenue Code there are various provisions of the nonrevenue type, and the government is being more and more urged to expand this regulatory or policing use of the taxing power. One strong advocate of extensive nonfiscal use of the taxing power has gone so far as to assert that the accomplishment of positive social or economic objectives beyond the revenue is the "highest function" of taxing. I submit that this is a mistaken view.

For my own part, I am clear that the highest function of taxes is to get revenue—important as certain social or economic objectives are. I submit also that in deciding how far to go in mixing regulatory or policing functions with the revenue-producing function, Congress must not only make up its mind whether the desired social or economic ends can actually be well accomplished through taxation, but also whether such enactments will have a bad effect on the continuous revenue-producing ability of our tax system.

Certainly the success of our tax laws as money-raisers in the past has rested solidly on the taxpayers' habits of voluntary compliance with tax laws. Contests between the government

and noncompliers are of course necessary to get full yield, as well as to assure the voluntary compliers that the noncompliers, also, will in the long run have to pay, but the great volume of revenue has to come in automatically rather than on the basis of deficiency notices, and no government can have a successful revenue system if it has to depend principally on coercive collection.

Our tax-complying habit is so valuable and so delicately poised that it must be carefully conserved; its continuance cannot be taken for granted. To a considerable extent it is based on the taxpayer's sound feeling that the duty of contributing to his nation's running expenses is analogous to that which a breadwinner has in supporting his own family. There is reason to doubt the continuance of existing taxpayer attitudes, which are based largely on such feeling, if the nonfiscal elements in our system are increased to a point where the taxing act will be thought of as largely compulsive in purpose. This is because compulsive laws are traditionally resented and resisted by our people—as was illustrated by the public reaction to the national prohibition law. Fortunately, although that law was mainly administered by the Treasury and was armed with summary enforcement such as applies to internal revenue taxes, its administration could be kept quite separate from the administration of tax measures. This separateness prevented it from injuring the revenue-producing system as much as it might otherwise have. Much of the nonfiscal tax legislation now proposed could not be so easily separated from those parts of the taxing act on which we must rely for largest amounts of revenue.

Another point of importance in this connection is that social objectives in legislation are almost always storm centers of political feeling, and where such objectives are sought through taxation, the more fundamental question of getting adequate revenues may thus become entangled with partisan politics, against the public interest.

Conclusion

To be successfully administered, a tax law needs to be sound and needs to be respected as such by taxpayers. Skillful administrative officials can go a considerable distance in keeping an ill-advised tax law from failure, but although Congress is never responsible for actually putting the tax law into effect—for working it—Congress is finally responsible for its workability.

This is because its workability depends primarily on the substantive provisions of the law—the rules by which the dollar liability of each taxpayer is to be determined. The establishment of such rules is strictly a legislative function. Congress is responsible not merely for laying down these rules in the first place; I believe it has the further duty, whenever judges or administrative officials undertake to make new rules of this type, or to make substantial changes in any such rule, of either writing such changes into the act itself or of so reframing the law as to disaffirm the changes.

These heavy responsibilities are the more difficult to carry out because Congressmen and Senators, in addition to making up their own minds as to what the tax law should be, must exercise such qualities of leadership that their own constituents, and public opinion generally, will back up sound tax legislation after it is enacted. That such leadership has to a reasonable degree been exercised is demonstrated by our country's record of courageous and timely tax legislation.

Finally, it would be disastrous indeed, from the government's standpoint, if Congressmen and Senators merely kept their ears to the ground, advocating tax laws based only on what they hear. It is true enough that they are forced to give weight to public opinion, but it is also true that public opinion in these matters depends, and should depend, to a considerable degree on the quality of leadership which members of Congress bring to their task. Fortunately, the public is wise enough to expect leadership rather than mere subservience from their elected representatives.

CHAPTER III

RESPONSIBILITIES WHICH SHOULD BE MET BY EXECUTIVE DEPARTMENTS

EDWARD H. FOLEY, JR.
Under Secretary of the Treasury

PRACTICAL necessity demands that most tax forums be concerned principally with the tax man's daily bread-and-butter problems: what salary is reasonable, what deductions are allowable, or what's new in 102. It would be most unfortunate, however, if the private tax man were to live by bread alone, so to speak. Fortunately, a number of private tax experts are devoting a large portion of their time to the broad phases of tax administration. It is encouraging to find that this is being done. The Institute is to be commended for its concern with the broader phases of the tax problem, as is indicated by the topics being discussed in this symposium. It is particularly gratifying to know that men of the caliber of Mr. Miller, Mr. Angell, and my distinguished predecessor, Mr. Ballantine, are also sufficiently interested to bring to this subject the high standards of analysis and erudition which have always characterized their work. Mindful of their interest, I want to outline briefly the responsibilities which I think should be met by executive departments, particularly my own.

When one speaks of the Treasury Department in connection with tax administration, it is natural first of all to think of the relationship of the Bureau of Internal Revenue to taxpayers. But that relationship is not to be my primary concern this afternoon, since it is to be treated by other speakers. It is my purpose to concern myself with the broader aspects of tax ad-

ministration, namely, the role of the executive branch in the formulation of tax policy. Mr. Miller, in his excellent discussion, has described the operation of Congress with regard to tax matters. Completion of the picture requires an examination of the role which should be played by the executive branch in the formulation of basic policy.

Historical Precedent for Executive Participation in Tax Legislation

In recent times there has been some disposition to question the propriety of the executive branch taking part in the formulation of tax policy. There has even been some disposition to restrict its activities in this connection. That viewpoint, with which I am not in agreement, arises from a vague notion that policy-making and planning are exclusively a function of the Congress; that the executive branch should confine itself to the enforcement and administration of rules enacted by the Congress. Evidence of this attitude may be seen in the desire on the part of some to question the appropriations for the staff which assists the Secretary of the Treasury and the President in the formulation of the administration's tax policy.

So that there can be no mistake about it, let me say at the outset that I do not question the fact that the ultimate and final responsibility for the determination of legislative tax policy rests with the Congress. The point I want to make is simply this: tax legislative planning, in my judgment, is not solely a function of the legislative branch. The executive branch of the government can and should have a hand in the development of national policy. Indeed, the Constitution contemplates cooperation toward this end. Article 2, section 3, provides that the President "shall from time to time give to the Congress information of the State of the Union, and recommend to their Consideration such Measures as he shall judge necessary and expedient."

The need for this cooperation is not difficult to perceive. Congress operates through committees organized on functional

lines. The committee work is, to say the least, back-breaking. The most that can be expected from each committee is that its members will keep up with the details of the subject matter in their particular field, and that they will arrive at reasonably adequate solutions of the problems falling within their jurisdiction. It is too much to expect that each committee can keep pace with the work of its sister committees. Moreover, the creation of a balanced national program frequently requires that the desires of some committees must be subordinated to the recommendations made by others. Because each committee is autonomous and is not, except perhaps indirectly, subject to the control of any other, correlation of their respective programs is not readily feasible. In early times, when life was simpler, the lack of centralized coordination ordinarily did not hamper the formulation of an integrated legislative program. Throughout most of the nation's history, however, the Congress has recognized the value, and availed itself of assistance from the executive branch.

If historical precedents are necessary to supply the authority of tradition for executive participation in the legislative process, instances from the earliest days are not lacking. Even under Washington, as Edwin Corwin has pointed out in his authoritative work on the office and powers of the President, the principle of separation of powers was not regarded as forbidding the President to propose legislation. Jefferson had a constant guiding hand on Congressional policy, although he made use of a party "Congressional Caucus" for the purpose—a sort of kitchen door approach. Jackson made the Presidential office an influential force in legislation, even though expressed mainly through use of the veto power. Later Theodore Roosevelt was so successful in influencing the course of legislation that his activities were severely criticized. His successors, Taft and Wilson, also played a large part in shaping legislative policy.

The present practice of sending administration drafts of legislation to the Congress probably began during Theodore Roosevelt's administration. Witness the Pure Food and Drug

bill in 1906, drafted by the Department of Justice. Proposed bills drafted in White House conferences were accepted in large part by the Congress and became the Federal Reserve Act of 1913.

As is commonly known, later Presidents have not hesitated to participate in legislative planning; rather the practice has grown to maturity and is an accepted procedure. The organizational problems of Congress in handling difficult legislative matters in recent years has no doubt contributed to this participation. But executive influence could not have developed as it did under President Franklin Roosevelt without Congressional recognition, tacit though it may have been, that the assistance is helpful and necessary.

Importance of Executive Participation in Tax Legislation

Today when the nation's life is more complex than ever before, participation by the executive branch in legislative planning is especially important. Aside from the added burden of governmental responsibility that has accompanied the tremendous increase in our population to its present figure of some hundred and forty million, the trend of the times has seen ever increasing concern by the government with the welfare of the individual. Added to the burdens of Congress are those engendered by recognition of the fact that there is now greater political and economic interdependence among nations than has ever existed before. As a consequence, it has become necessary to consider legislation not only from the standpoint of its national effect, but also in the light of the impact of world problems upon our national life.

Congress itself has recognized the need for adapting its method of operation to the increasing demands upon it. As one step it has sought to strengthen its organization through the enactment of the Legislative Reorganization Act. In the all-important field of government finances, the Congress has sought to provide the much needed correlation between government

receipts and expenditures by directing the committees of Congress responsible for revenue and appropriations to cooperate in the recommendation of a legislative budget. It has also provided for increases in its own staffs of permanent technical advisers.

These moves are, of course, highly desirable. They will undoubtedly be helpful in achieving consideration of problems from an over-all standpoint. Developments in the last Congress, however, indicate that these measures are not the complete solution to the problems of legislative planning. You will recall that in practice various factors did not permit the development of the legislative budget as contemplated by the Reorganization Act. You may also remember the conflicting decisions of the House Appropriations and Foreign Affairs Committees regarding the amount to be provided to carry out the European Recovery Act. So, too, increasing the number of technical advisers has not made assistance from the executive branch of government unnecessary.

The need for participation by the executive branch in legislative planning is particularly pressing in the field of taxation. For one thing, it is a matter of good business practice to have close cooperation between the appropriating branch and the collecting and spending branch in the shaping of a tax program. Moreover, taxation today affects every part of our economy. Intelligent tax planning, therefore, calls for integration of a great variety of considerations that are the concern of many and diverse agencies of government. Personal exemptions under the income tax laws must be viewed with some regard to subsistence needs and hence with regard to changing price levels. Rate levels may exert an important effect on the living standards and spending patterns of almost all of the population. Corporate tax rates and methods of taxation may influence the growth and development of new business enterprises which are essential to a dynamic and expanding economy. Excise taxes are important variables in the lives and well-being of whole industries. Interest rates, credit controls, and other general

aspects of the government's fiscal program are all influenced by federal tax policies.

Qualifications of Executive Branch to Participate in Formulating Tax Program

The executive branch of the government—the Treasury Department in particular—is especially qualified to assist Congress in formulating a tax program which is fiscally sound and which is in harmony with other national legislative programs. The Treasury has a staff of technicians continually engaged in gathering and analyzing facts on various phases of our economic life. For example, the Office of International Finance conducts studies of economic conditions in foreign countries. These studies are invaluable in the solution of monetary and currency problems related to our foreign trade; they are likewise useful in the formulation of our foreign aid programs. The Office of the Technical Staff, which is charged with the duty, among other things, of preparing revenue estimates in connection with the President's budget, must keep itself abreast of changing business conditions. It is thus well suited to supply information essential to the formulation of proper fiscal policies.

In performing these functions the Treasury draws upon its own vast experience in this type of work. It seeks the advice of other governmental agencies. It has the benefit of the studies by private research groups. It consults with representatives of commerce and industry and prominent figures in the academic world. The assistance of these groups is utilized both with respect to the broad aspects of economic life and in specialized fields such as taxation.

The group within the Treasury Department which assembles the facts and prepares the economic, statistical, and technical analyses necessary to the tax phase of the Treasury's activities is the Division of Tax Research. That division prepares basic surveys of the tax problems of the federal government, studies alternative methods of meeting revenue requirements, and

analyzes methods of adjusting the tax system to changing economic conditions. It analyzes the tax system not only with a view to obtaining revenue yields large enough to meet prospective requirements, but also with a view to making adjustments which will be fair to taxpayers and avoid undesirable economic effects. As part of this work, it studies the taxes affecting individuals to determine their effects on particular groups of taxpayers, to avoid inequity among taxpayers within a given group, to ascertain methods of meeting administrative and compliance problems, and to devise ways of integrating particular taxes with the tax system as a whole. In the course of these studies, it makes technical analyses of the problems inherent in various tax measures, and it makes statistical analyses of the distribution of the burden of specific taxes, the total federal tax load, and the combined federal, state, and local burden.

In recent years the division has worked primarily on the problems of postwar federal tax revision. It has conducted studies of a number of major tax items in the fields of business taxes, individual income taxes, excise taxes, estate and gift taxes, and social security taxes. Some of the better known of these valuable studies are "The Postwar Corporation Tax Structure," "Income Tax Treatment of Pensions and Annuities," and "Taxation of Small Business." Considerable material, including a study on "The Tax Treatment of Family Income," was prepared in connection with the Revenue Act of 1948. These technical studies were released to the public and demand has exceeded our available supplies.

In the preparation of its studies, the division frequently calls upon the services of outside experts in order to get the benefit of their experience and observations both as economists and as authorities in the field of fiscal policy and taxation. Recently, for example, the division sought the views of economists, accountants, and representatives of industry in connection with its study of depreciation problems. There have been counted among the division's consultants over the years a number who

are currently members of your own Advisory Council: Roy Blough, Harold M. Groves, James W. Martin, Lawrence H. Seltzer, and Carl Shoup.

Legal studies as well as economic studies must form the groundwork for determination of tax policy by the Secretary of the Treasury. Study of the legal, technical, and administrative aspects of recommendations for changes in the tax system is the function of the Tax Legislative Counsel who, together with his staff, comprises a part of the Office of the General Counsel. Equally important is constant surveillance of the judicial and practical application of existing law to detect and take action to close loopholes and to prevent inequities which may be present. One of your former presidents, Thomas Tarleau, not so long ago was Tax Legislative Counsel of the Treasury Department.

In carrying out his duties the Tax Legislative Counsel keeps abreast of tax legislative needs in a variety of ways. He and his staff confer with tax attorneys, accountants, representatives of commerce and industry, and representatives of various professional groups such as your own, the American Bar Association, the American Bankers Association, American Institute of Accountants, and Life Insurance Association of America. It is his function to analyze legislative recommendations made by these and many other groups. In addition he has the assistance and experience of the Bureau of Internal Revenue in its continuous work of strengthening the administration of the revenue laws. The Tax Legislative Counsel is thus in an especially good position to evaluate the merits of tax proposals from the viewpoint of taxpayers as well as that of the tax collector. In connection with this work, he must, of course, study the legislative history of existing law, current court decisions, and departmental rulings. These processes are continuous in order that the department may be in a position to present its views effectively whenever the Congress considers a tax bill.

To improve the equity and administration of our tax system as applied at the international level, the Tax Legislative Coun-

sel represents the Treasury Department in international tax matters. Members of his staff, as well as representatives of the Bureau of Internal Revenue, participate in the negotiation of treaties for the prevention of international double taxation and for administrative cooperation between the United States and other nations.

When the office embarks upon studies of technical problems of a more extensive nature, it enlists the cooperation of advisory committees composed of prominent tax authorities outside the government. An example is the study entitled "Federal Estate and Gift Taxes—A Proposal for Integration and for Correlation with the Income Tax." This study was prepared jointly by the Tax Legislative Counsel, the Division of Tax Research, the Bureau of Internal Revenue, and an advisory committee consisting of George K. Bowdin of Chicago, Jesse R. Fillman of New York City, Lawrence E. Green of Boston, Dean Erwin N. Griswold of Cambridge, and Harry J. Rudick of New York City. Although, as anticipated, this project has given rise to considerable controversy, in which I believe some of you have engaged, it appears to be generally agreed that the project was a very worthwhile one. The help of the outside experts was indispensable.

The primary purpose of the work done by the Division of Tax Research and the Tax Legislative Counsel is, of course, to prepare materials and recommendations for use by the Secretary of the Treasury in determining Treasury policy. The work of each office is a specialty; they contribute different and necessary elements to the whole program. Decisions in many matters are arrived at only after consultation with other members of the cabinet, the Council of Economic Advisers, the Bureau of the Budget, and when the situation requires, the President himself. Once the executive program has been decided upon the Treasury Department is in a position to work with those in the legislative branch who are charged with tax planning, that is, the Committee on Ways and Means and the Senate Finance Committee.

Everyone knows, of course, that the views of the executive branch will not always coincide with those of the Congress. But whether there are differences or not, and whether those differences are over matters of detail or are more fundamental, there is always room for Treasury participation. Actually, as well as historically, the Treasury Department is the repository of accumulated fiscal knowledge. This knowledge is available to the executive branch and to the public at large as well. It is and should be available to the legislative branch.

The joint efforts and close cooperation of both branches of government have, over a period of years, produced a tax system supplying the necessary revenue which, at the same time, has been designed to operate equitably and to encourage private initiative. We in the Treasury look forward to a continuation of those results through cooperation with the Eighty-first Congress and subsequent Congresses.

CHAPTER IV

RESPONSIBILITIES WHICH SHOULD BE MET BY EXECUTIVE DEPARTMENTS

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THE PROBLEM

THE CONGRESS enacts and presents to the executive departments the revenue statutes which comprise our scheme of taxation. The duty falls upon the executive departments to interpret, administer, and enforce such statutes. These statutes cover a variety of taxes: the individual and corporate income taxes, the estate taxes, the gift taxes, and the excise taxes. Many of these different taxes touch one upon the other, and frequently the adoption or rejection of a principle of substantive law will govern the application of two or more of these different taxes.

In order that our entire scheme of taxation be given unity and integration, it is necessary that there be developed certain broad policies of interpretation, which will insure a fair, just, and equitable program of enforcement. Unless these policies are framed on a comprehensive basis with a view of integrating our entire scheme of taxation, we are bound to experience incongruous results. Distortions will appear here and there, requiring frequent statutory amendments in order to overcome them. Nothing can be more subversive to a normal and healthy growth and development of our income tax structure than what I may call a piecemeal method of interpretation.

The Commissioner of Internal Revenue, as the head of the

Bureau, is of course charged with the duty of framing the broad policies which should control in interpreting the revenue laws. In the first instance, the problem of interpretation and enforcement is administrative, although in performing the administrative duties the judicial function must be exercised within the Bureau. To this end, the Commissioner is authorized to prepare and promulgate—with the approval of the Secretary of the Treasury—formal Regulations. The major function of these Regulations is to implement the statutes by elaboration, and by clarification in the event of any latent ambiguity. Thus, the Regulations are a major vehicle in shaping the interpretative and integration policies.

Under a system of voluntary return and self-assessment, the first impact of the statute upon the taxpayer's affairs arises on examination and audit of a return. Out of such an audit, controversies arise, and the second major vehicle in shaping the interpretative and integrating policies is the settlement of such controversies in the form of published and unpublished rulings, which supplement the formal Regulations.

With the advent of decentralization and the administrative determination of tax controversies largely occurring in the field, uniformity of interpretation and enforcement became more difficult of accomplishment. But these obstacles are now largely overcome through intra-Bureau rulings and post-audit review in Washington, thus insuring a unity of administrative interpretation and enforcement, and proper integration between the several kinds of taxes.

But the main vehicle of interpretation and integration are the litigated controversies which find their way into the courts. Because in such cases the Commissioner is a litigant and not the arbiter, it is here where the major problem of achieving unity and integration arises. The Commissioner through his attorney presents the Bureau view, a view which, since it is now the view of an advocate, is often colored by advocacy. The taxpayer through his attorney presents his views, which invariably are colored by self-interest in the particular case,

without regard to the effect of the decision on the broad sweep of our scheme of taxation. Upon the basis of these two divergent views, neither of which can be said to be impartial, the bench in question must undertake to interpret and apply the statute as best it can. Without a rounded knowledge of our whole scheme of taxation, and frequently without any real appreciation of the major simple principles which underlie such scheme, the judiciary will reach a result which from a broader standpoint is quite disconcerting and often requires a change in the interpretation of a wholly different provision of the law, and, indeed, a different class of tax.

For example, under Bureau interpretation and Bureau rulings, the settlor of a trust who had surrendered the right to retake for himself income and corpus but who had reserved the right to change beneficiaries, was deemed to have made a gift when he relinquished the power to retake for himself. The income tax rule was in accord. So long as the settlor had the right to retake for himself, the settlor was required to pay income taxes in respect of the trust income, but upon the surrender of such a right, even though he reserved the right to change the beneficiaries, the income tax burden passed from the settlor to the trust—or to the beneficiaries.[1]

Then the *Sanford* case arose, involving a gift tax of $1,000,000. Administratively, the Bureau re-examined the existing rulings, and because the rulings were sound in principle, and a change of rule would necessarily result in great confusion and possible loss of revenue over the long run, it reiterated the existing rule, even at the expense of losing currently a very substantial tax. This was sound policy.

A year or so later, the *Hesslein* case arose in a Federal District Court, where it was in the interest of the taxpayer to postpone the gift tax until all powers were relinquished. The United States Attorney adopted and argued the Bureau view,

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[1] *Knapp* v. *Hoey,* 24 F. Supp. 39 (S.D. N.Y., 1938), *aff'd,* 104 F. (2d) 99 (C.C.A. (2d), 1939).

namely, that a gift tax occurred on the surrender of the power to retake. The District Court sustained the taxpayer.[2]

The government then appealed to the Circuit Court of Appeals for the Second Circuit and the Circuit Court, overruling the government's contentions, affirmed, thus upsetting the prevailing administrative rule.[3] The government applied for certiorari but it was denied. Confronted with this decision, the Bureau reopened the *Sanford* case and issued a deficiency notice. A case was made on an agreed statement of facts before the Board of Tax Appeals, which followed the Second Circuit Court's decision in the *Hesslein* case. On appeal to the Third Circuit, the Third Circuit affirmed on the basis of the Second Circuit's decision, indicating, however, that had it not been for such decision, it would have reversed.[4]

In the meantime the government, not giving ground nor losing heart, had brought up and lost another case involving the identical question in the Second Circuit.[5] Petitions for certiorari were filed in the *Sanford* case—by the taxpayer—and in the *Humphreys* case—by the government—and both petitions for certiorari were granted.

The two cases were argued before the Supreme Court on the same day. Although respondent in one case and appellant in the other, the attorney for the Department of Justice insisted on maintaining a rigid neutrality, even though repeatedly urged by the Chief Justice to state which position the Department of Justice believed to be sound. Without any guidance from the government as to the Bureau's view, the Supreme Court affirmed in both cases, thus finally upsetting the established Bureau rule.[6]

With the finality of the decision, the existing income tax rule was considered not in line, and, accordingly, the administrative rule was changed so as to impose the income tax on the

[2] *Hesslein* v. *Hoey*, 18 F. Supp. 169 (S.D.N.Y., 1937).
[3] *Hesslein* v. *Hoey*, 91 F. (2d) 954 (C.C.A. 2d, 1937).
[4] *Sanford's Estate* v. *Commissioner*, 103 F. (2d) 81, 83 (1939).
[5] *Humphreys* v. *Rasquin*, 101 F. (2d) 1012 (1939).
[6] *Estate of Sanford* v. *Commissioner*, 308 U.S. 39 (1939), and its companion case *Rasquin* v. *Humphreys*, 308 U.S. 54 (1939).

settlor so long as he retained the power to change beneficiaries, even though he already had relinquished the power to retake, and the courts have now given their blessing to the changed rule.[7] This was in 1939. Both Bureau and taxpayer are still struggling over innumerable cases affected by this fundamental change of rule. But in the meantime Congress was forced to enact a relief measure occasioned by and growing directly out of the change of rule.[8]

Had the Department of Justice taken a firm position in support of the Bureau's original administrative rule when the issue for the first time was squarely before the Supreme Court in the *Sanford* and the *Humphreys* cases, the Supreme Court might, and very probably would, have sustained the original Bureau rule. But without leadership from the government, the Supreme Court was left to resolve the issue as best it could. The decision in the *Sanford* case has often been attacked as unsound and as resulting in the loss of revenue. Certainly great confusion has followed in its wake. All of this probably could have been avoided had the Department of Justice adopted a firm position in support of the original administrative rule.

This illustration is only one of many which serve to indicate the importance of intelligent control exercised by the executive departments over litigated cases. In the past ten years there have been at least five instances in which decisions of the Supreme Court have resulted in such violent distortions of the general scheme of our revenue laws that Congress has overturned such decisions by amendatory legislation.[9] In four of

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[7] *Commissioner* v. *Buck,* 120 F. (2d) 775 (C.C.A. 2d, 1941); *Brown* v. *Commissioner,* 131 F. (2d) 640 (C.C.A. 3d, 1942).

[8] Many taxpayers, relying upon the original rule, had filed gift tax returns and paid tax on the relinquishment of the power to retake, yet under the new rule, a gift tax arose upon the final surrender of all retained powers, thus exposing such taxpayers to a double gift tax liability. Accordingly, by Section 502 of the Revenue Act of 1943, Congress provided that where a gift tax had been paid on the surrender of the power to retake, there would be no liability for a gift tax on the surrender of the remaining powers, limiting the relief, however, to final surrenders after June 7, 1932 (the date of the second gift tax act) and before January 1, 1940.

[9] *United States* v. *Hendler,* 303 U.S. 564 (1938) holding that the assumption of debt rendered taxable an otherwise nontaxable reorganization; overruled by

these cases the Supreme Court review was initiated by the Department of Justice, and in the fifth, an affirmance, the government won below. But the views of the Department of Justice, although upheld by the Supreme Court, were promptly repudiated by Congress. With appropriate and effective control over appeals in tax cases, this incongruous situation could have been avoided.

The Present Method of Meeting the Problem

The existing division of authority between the Bureau on the one hand and the Department of Justice on the other is not, it seems to me, conducive to a unified policy of interpretation. The Bureau attorneys handle cases initiated in the Tax Court of the United States. When the Tax Court has spoken, and in the event of an appeal, the jurisdiction over the appeal passes to the Department of Justice, where the case remains until final decision. A case initiated in the federal District Court is handled by the local United States Attorney's office which, of course, is under the Department of Justice. A case arising in the Court of Claims is also in the exclusive jurisdiction of the Department of Justice. Indeed, in these two classes of cases the entire litigation is in the hands of the Department of Justice.

The initiation of all these classes of cases lies with the taxpayer, which necessarily means that the Commissioner of Internal Revenue has already taken a position administratively. The question of upon what theory the defense should be made

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Section 213 of the 1939 Revenue Act, now I.R.C. Section 112(k); *Helvering* v. *Enright,* 312 U.S. 636 (1941) requiring the inclusion in the prior to death return of a deceased partner's rights to receive partnership fees; overruled by Section 134 (e) of the 1942 Revenue Act, now I.R.C. Section 126; *Helvering* v. *Bruun,* 309 U.S. 461 (1940) holding the recovered improvements on a forfeited lease were income; overruled by Section 115 of the 1942 Revenue Act, now I.R.C. Section 22(b) (11); *Helvering* v. *Stuart,* 317 U.S. 154 (1942) holding that income of a trust distributable to the children was taxable to the settlor whether or not in fact distributed; overruled by Section 134 of the 1943 Revenue Act, now I.R.C. Section 167(c); *Higgins* v. *Commissioner,* 312 U.S. 212 (1941) holding that a nonbusiness investment expense is not deductible although incurred in managing personal investments; overruled by Section 121 of the 1942 Revenue Act, now I.R.C. Section 23(a) (2).

is of importance. But the necessity of effective control really arises at the point where a decision must be made whether or not a judgment of the Tax Court or of a District Court shall be reviewed; and, again, following the judgment of the Circuit Court of Appeals or of the Court of Claims, whether certiorari should be applied for in the Supreme Court. In these several instances a decision must be made, and it is at this point that effective control should be exercised, with a view of insuring an appropriate interpretation and of avoiding distortions.

Without any exact knowledge as to how the problem is now being handled, it is my understanding that, in the case of an adverse decision of the Tax Court, a group within the Bureau meets and decides whether the Bureau recommends for or against an appeal. Once the recommendation is made, it is forwarded to the Department of Justice. Although according great weight to the Bureau recommendation, the Department of Justice, I understand, reserves the power to act independently in making the final decision. In cases arising in the federal District Court, I presume that, again, the Bureau makes a recommendation, but that the Department of Justice, while usually following it, may on occasion act independently.

Because of the overlapping of authority and the practice of the Department of Justice to review a case fully before deciding whether or not an appeal will be perfected, the question must be twice considered; first, in the Bureau in formulating a recommendation and again in the Department of Justice in making the decision. The Tax Division of the Department of Justice, headed by an Assistant Attorney General, now comprises a large group of attorneys, whose duties include the weighing of the considerations for and against the advisability of appeal, with a view of reaching a decision independently of the Bureau. This means that the Commissioner of Internal Revenue is not the sole arbiter, but that the Department of Justice shares with him the authority to make the decisions on appeals. The result is a duplication of effort.

Perhaps as a result of the lack of a unified control over

appeals, or perhaps because of the frailties of human nature, experience has shown that the controlling consideration for or against an appeal is the amount of money involved or whether the Department of Justice feels that there is a reasonable likelihood of a win. Assuredly, there has been little evidence in the past years indicating that the decision is rested upon any broad-range policy of interpretation and integration. To permit the decision to turn either upon the chances of success in the given case or upon the amount of money involved, or upon both, results in what I have called a piecemeal interpretation of the statute.[10]

The amount of money involved should not be regarded as an important factor in deciding whether to appeal or not to appeal a given case. Our revenue scheme is based upon the principle of equality in application and enforcement; an equality, not only between the government and the taxpayer, but an equality among taxpayers, big and little. Whether a certain interpretation ascribed to a provision of the revenue law results in a tax of $10 or $1,000,000 should be of no consequence. The important thing is to strive for an interpretation which will conform to an integrated and comprehensive system of levying taxes. If we can be assured of a well-rounded system predicated upon a sound body of substantive law, if we can achieve a system which will be fair and equitable among tax-

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[10] There have been occasions where the Department of Justice has taken positions in conflict with the Commissioner's own Regulations. For example, in *Langstaff* v. *Lucas*, 9 F. (2d) 691, (W.D. Ky., 1925) the Collector frankly argued that the Regulations involved were invalid; in *Helvering* v. *R. J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939) the Commissioner sought to impose a tax on the profits realized by a corporation upon the purchase of its own stock, although under the applicable Regulations such a transaction did not result in taxable income; and in *Helvering* v. *Minnesota Tea Company*, 296 U.S. 378 (1935) the Commissioner contended that a certain transaction was taxable when under the existing Regulations it was a nontaxable reorganization. More recently, in *Helvering* v. *Griffiths*, 318 U.S. 371 (1943), the Commissioner contended that a stock dividend in common stock on common stock was taxable, even though the applicable Regulations in effect at the time of the dividend declaration clearly stated that such a dividend was not taxable. Before making the case, the Commissioner had taken the precaution of changing the Regulations. The attack really was an attack upon the validity of the original Regulations, which the Supreme Court was quick to perceive and point out. The Court upheld the earlier Regulations. The Regulations as changed are still in effect.

payers however circumstanced, the question of revenue may readily be met by an increase or decrease in the rates.

The chance of success in a given case certainly should not play a major part in deciding whether an appeal should be taken. Cases which, for one reason or another, have proven easy to win on appeal, have often given rise to a distortion, sometimes even requiring correction by statutory amendment. On the other hand, a number of the major principles which underlie our taxing statutes have called for the utmost effort of government attorneys to sustain. The courts frequently have proved stubborn, yet, with the power and influence of the government behind a case, if the case involves a principle of major importance, the government should not hesitate to go forward. Mr. Solicitor General Lehman had a saying: "Whenever the case is rightly decided, the Government wins." This is a principle which may well be borne in mind in undertaking to interpret and apply our revenue statutes.

As things exist today, and as they have existed for some time, there is certainly room for improvement in the means and methods of making decisions on appeals, even within the framework of our present division of authority between the Commissioner of Internal Revenue and the Department of Justice.

The Suggested Solution

It has been suggested that the handling of tax cases in the federal District Courts should be by attorneys of the Bureau, and that when a case reaches an appellate court, whether from a federal District Court or the Tax Court, a Bureau attorney should continue to handle the case. In this fashion, it is said, all litigation in tax cases would fall under the supervision of the Commissioner of Internal Revenue, thus assuring unity of interpretation and integration.

Again it has been suggested that if litigated cases are continued to be handled as at present, the final determination as to whether or not an appeal is to be taken should lie with the Commissioner of Internal Revenue, acting through his

Chief Counsel, and that the Department of Justice, while supplying the necessary attorneys to represent the government in presenting the case, should have no voice in determining whether an appeal should or should not be taken.

These solutions, while, perhaps, having much to commend themselves from the standpoint of centralizing the policy-making powers, nevertheless would cut sharply across the existing practice, and would relegate the Department of Justice to a subordinate position in tax problems. But there is, it seems to me, a solution which will avoid the difficulties and at the same time assure a unified control over the policy of appeals. Handicapped, perhaps, by the fact that I have never served in the Bureau or in the Department of Justice, nevertheless, with some timidity, I suggest the solution.

I suggest that there be created within the Bureau of Internal Revenue a committee or group of three attorneys, two appointed by the Commissioner and one appointed by the Attorney General. In this committee there would be centered the whole problem of unification and integration, whether arising in connection with the formal Regulations of the Commissioner, or in the formal and informal rulings made in the course of administrative contests, or in the course of litigated cases in the courts.

It would be the sole and exclusive duty of this committee of three to exercise directive control over the interpretation and integration of all our revenue taxes—income, gift, estate, and miscellaneous. Taking the formal Regulations of the Commissioner as a main chart and compass, it would devolve upon the committee to direct and restrain all actions involving the interpretation of the several taxes, so as to insure a well-rounded and integrated scheme of taxation. To do this effectively would require close attention to and study of the formal Regulations and the amendments thereto, the propriety of published and unpublished administrative rulings and, above all, a familiarity with and control over all cases in litigation. Indeed, in view of the magnitude of our taxing system and the in-

numerable ramifications of its application, distortions are bound to occur, until we have some unified group charged with formulating general policies of interpretation and effectuating such policies through the various channels involved.

It will be said that this is a pretty big job. It is. But it is not, I believe, beyond accomplishment. It will, of course, require the selection of highly trained, broad visioned, and fair-minded men; it will require character of a high order; it will require familiarity with and constant attention to all litigated cases pending in the Tax Court, the federal District Courts, the Court of Claims, and the appellate courts. But, if such a group can be successfully created, and we have patience while it is organizing and grappling with the problems, it will, I feel assured, accomplish much in the saving of time, in the avoidance of long-drawn-out controversies, and in the need for amendments occasioned by short-sighted prosecution of appeals.

I have suggested a committee comprised of two attorneys appointed by the Commissioner and one by the Attorney General.[11] This seems to me an appropriate balance. The Commissioner, primarily, is charged with the responsibility of giving a well-rounded and appropriate development to our revenue statutes through the process of interpretation and integration, and, accordingly, he should be the directive force in the exercise of controls. But the Tax Division of the Department of Justice has now had long experience in tax controversies. It has struggled with the meanings of obscure and sometimes conflicting provisions. It is familiar with the mass of court decisions, and, of course, ultimately it is called upon to present the government's case on a given question of interpretation. Accordingly, it should have a representative on the policy-making committee. Through this representative on the committee, the Solicitor General would have a voice in reaching controversial decisions involving the advisability of appeals.

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[11] If a committee of three is deemed too small, it could be increased to five, of which three would be appointed by the Commissioner and two by the Attorney General.

The finality of the decisions of such a committee should, perhaps, vary depending upon the particular vehicle of interpretation involved. The Commissioner is charged with the formulation and promulgation of the Regulations, with the approval of the Secretary of the Treasury. The Regulations before promulgation should be submitted to the committee for its views, but in this field the decision of the Commissioner should be final. In the same way, published and unpublished rulings should be considered by the committee, but here again, since the matter of interpretation is purely administrative, the committee should be advisory and the final action should rest with the Commissioner.

In litigated cases, however, certainly in questions involving whether or not an appeal should be taken, the determination of the committee should be made final and binding. This is for two reasons. First, unity of control over appeals can be exercised properly only if power of control exists in one group. Secondly, in view of the interdepartmental division of authority neither the Bureau alone should have the final decision nor should the Department of Justice alone have the final decision; the decision should be made jointly through the representatives of each, but once so made it should not be subject to further review.

In closing, let me say that I have approached this problem and the solution, not in a critical attitude, but with a view of meeting a problem which experience has shown is grave and not easy of solution. As our income tax statutes become more intricate, there is a greater tendency toward piecemeal interpretation, for it is the line of least resistance. Perhaps it is the detail and particularity in provision which have given the courts the most difficulty. Where a case is centered upon the meaning of a certain provision, it is difficult for the courts to realize the often far-reaching effect which will result from assigning to such a provision a certain interpretation. Indeed, it is not the function of the courts to give direction to the broader play of the revenue laws or to undertake to formulate

and apply basic policies of interpretation and integration. This, it seems to me, is the duty of the executive branch of the government. In fulfilling this duty, the attorneys charged with presenting the case for the government should endeavor to assist the courts in understanding the broader background upon which the interpretation of the particular provision involved must rest. This means more direction and guidance by the executive branch than we have had in the past. Indeed, to carry out this duty, I should like to see the Judicial Code amended so that the Solicitor General may apply to the Supreme Court for a writ of certiorari in a case which the government has won below, but which, because of the importance of the principle involved, should be reviewed by the Supreme Court without delay, in order to secure an early and authoritative determination. Properly used, such a power would be of great assistance in the constructive effort of the executive branch to establish major principles deemed essential in a well-rounded and integrated scheme of taxation.

CHAPTER V

RESPONSIBILITIES WHICH SHOULD BE MET BY THE COURTS

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IN RECENT YEARS the federal courts have exercised very freely their prerogative of applying a tax statute not in accordance with its wording, but in accordance with the judges' view of the correct tax in the particular case before them. Desirable as the result in that case so obtained may seem to be, the general result of judicial increase or contraction of statutory wording has been to create confusion and uncertainty for those who properly seek to know in advance the tax result of contemplated transactions. That confusion will be eliminated only when courts return to permitting tax statutes to stand as written by Congress.

To reject the effect of a transaction which is a sham is the duty of the courts in dealing with tax questions as with other questions. To reject the tax effect of a transaction which conforms to the wording of a tax statute is not to deny recognition to a sham, but to deny recognition to the statute itself. The statutory line may not always be clear, but observance of the line when ascertained is essential to orderly and understandable taxation.

The two great questions which arise in so many aspects under the income tax law are (1) what is income, gross or net, and (2) to whom is particular income taxable. Striking instances of confusing court departure from tax statutes are to be taken from both fields.

Income Status—The Gregory Departure

The much discussed *Gregory* decisions in 1934 and 1935 (293 U.S. 465) were based upon reading in by the courts of qualifications not expressed in the statute, with uncertainty ever since as to what tax consequences may attach to corporate reorganization transactions of constant importance.

Receiving payment in the form of goods or securities of course does not put that payment beyond the reach of the income tax. But from the time when income tax rates became high it was recognized that for reasons both of fairness and policy the taxpayer's receipt of securities incident to a change in corporate structure ought not to be held to be a closed transaction giving rise to tax.

Recognizing the need for flexibility in business framework, beginning with the 1918 Act there have been included in the statute the so-called "reorganization" provisions. As Solicitor of Internal Revenue I happened to draw the first of those sections—Section 202(b) of the Revenue Act of 1918. That section, said the Senate Finance Committee, was designed "to negative the assertion of tax in the case of certain purely paper transactions." This phraseology was not apt, for if what was intended was to cover only what were actually "purely paper transactions," there would have been no occasion for the exemption provision.

As experience accumulated, it was perceived that situations arising as to corporate changes were many and complex. How they should be dealt with was emphatically a matter of tax policy for Congress. They could not be brought under a single provision or phrase. In the development of the Act more detailed reorganization provisions were included. The 1924 Act added a new Section 203(c)—Sec. 112(g) in the 1928 Act—which provided that:

> If there is distributed in pursuance of a plan of reorganization to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization,

without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee . . . shall be recognized.

This provision was inserted as covering "a common type of reorganization" falling within the general purpose of the reorganization provisions. The language used was very broad.

The *Gregory* case arose in 1932 under that Section, appearing as 112(g) of the Revenue Act of 1928, a section eliminated by the Act of 1934. The taxpayer, the sole owner of stock of the United Corporation, brought about a "reorganization" proceeding, by which a block of certain shares of stock of another corporation—the Monitor Corporation—was transferred to a specially created corporation—the Averill Corporation—the stock of that corporation being issued to her. The specially created corporation in the "reorganization" was dissolved three days later, and the block of Monitor shares transferred to it were distributed to her in liquidation. The taxpayer immediately sold the block of shares, and returned her profit as a capital gain.

The position of the Treasury was that the taxpayer had in effect received the block of shares as a dividend from the corporation which she owned, and that the tax due was a tax on a dividend amounting to $10,678 more than the tax on the capital gain from receipt of the Monitor shares through the reorganization route, as returned by the taxpayer.

There was no question but that the reorganization sections of the statute (Sections 203(g) and (h)) had literally been followed in the transaction, the literal consequence being capital gain and not dividend gain. Such was the conclusion reached by the Board of Tax Appeals (27 B.T.A. 223 (1932)) which sustained the taxpayer, stating:

A statute so meticulously drafted must be interpreted as a literal expression of the taxing policy.

On appeal, however, the Circuit Court was incensed by the idea that the use of the "reorganization" method instead of the dividend method of getting out the shares to be sold could

operate to accomplish the tax saving. So feeling, the Court was faced with the alternative of either accepting the clear result of the application of the reorganization section as written, presumably with a sounding of a warning note to Congress, or rejecting the terms of the statute and reaching the desired tax result. The wish for what seemed a satisfactory result in the case before the Court prevailed over any sense of need to adhere to the terms of the statute.

The opinion of the Circuit Court of Appeals, Second Circuit, written by Judge Learned Hand, holding that there had been no reorganization "within the meaning of the statute," stated (69 F. (2d) 809, at p. 811):

> the underlying *presupposition* is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholders' taxes is not one of the transactions contemplated as corporate "reorganizations." [Underscoring added.]

Sympathetic as one may be with the Court's feeling against the result of application of the words of the statute to the *Gregory* facts, one may question the reason assigned to justifying departure from the statute. As the whole purpose of the reorganization provision is to eliminate what would otherwise be stockholders' taxes, it follows that if a transaction falls within the provisions the stockholders' taxes cannot be said to be "dodged." And from what other than the *presupposition* of the Court was the "underlying presupposition plain" that the readjustment must be "germane to the conduct of the venture" to the satisfaction of the Court? What is covered would seem to be a question of Congressional policy as expressed by the words of the statute.

The Supreme Court without apparent hesitation supported the Circuit Court of Appeals. The Court stated (p. 469):

> the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.

Exercising its own judgment as to what was intended, the Court said:

When subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made "in pursuance of a plan of reorganization" . . . . of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either. . . . Simply an operation having no business or corporate purpose. . . .

The transaction upon its face lies outside the plain intent of the statute.

The opinion referred to the whole undertaking as "an elaborate and devious form of conveyance masquerading as a corporate reorganization."

In spite of the language of the opinion, the fact is that the transactions had actually occurred as maintained by the taxpayer and found by the Tax Court, and that under the literal terms of the statute they constituted reorganization transactions. There was then no "sham." The difficulty which aroused the Court was that the language of the statute did not confine the exemption to cases which the Court would approve. Limitations later inserted in the Act might have so confined the exemption, but such limitations were not placed there originally.

As to the treatment of Section 112(g) in the *Gregory* decisions, justification for the Court view may be argued from the elimination of that section by Congress in enacting the Revenue Act of 1934 for the reason assigned by the Ways and Means Committee in repealing that legislation (H.R. Rep. No. 704, 73d Cong. 2d Sess. 14 (1934)) that

By this method corporations have found it possible to pay what would otherwise be taxable dividends, without any taxes upon their shareholders.

The elimination of the section, however, instead of placing a specific limitation upon it, left the statute without provision for exemption of corporate simplifications by a "spin-off" recognized to be frequently desirable.

Last spring the Joint Committee on Internal Revenue Taxation proposed that the "spin-off" substance of old Section 112(g) be restored to the Code, with the limitation that the exemption should not apply if

it appears that any corporation, a party to such reorganization, was not intended to carry on business after such reorganization and the corporation whose stock is distributed was a mere device for the distribution of earnings and profits to the shareholders of any corporation a party to the reorganization.

That proposal was approved by the Ways and Means Committee and the section so limited was included in the act so passed by the House of Representatives. That Congressional action was a sound development.

The limitation suggested by the Court in the *Gregory* decisions led to grave uncertainties under provisions of the reorganization section other than those involved in the *Gregory* case.

In the *Bazley* case (331 U.S. 737 (1947)), the courts denied as a recapitalization within the meaning of the exempting section (Sec. 112(g) (1) (E)) a reconstitution of the capitalization of a corporation from common stock into common stock and debentures. A husband and wife owned all but one share of the 1,000 shares of common stock originally outstanding. The company had an earned surplus of $850,000. Under the recapitalization plan the shareholders received in place of the original stock their proportion of 5,000 shares of new common and $400,000 of twenty-year debentures, callable in whole or in part.

The Commissioner ruled that the transaction did not constitute a "recapitalization" and that the debentures were received as a dividend. The Tax Court (4 T.C. 897, 904 (1945)) with five dissents sustained the Commission on the ground that the recapitalization, while desired by the stockholders, lacked "a legitimate corporate business purpose within the *Gregory* principle." The Court rejected testimony that the shareholders wanted the new capital stock available in smaller units for distribution among key employees.

The Circuit Court of Appeals sustained the Tax Court, and the Supreme Court sustained the Circuit Court of Appeals. The Supreme Court avoided discussing the "business purpose"

doctrine and relied upon a "net effect" test, maintaining that the debentures distributed were essentially equivalent to cash and could have been retired at the will of the recipients. Similar results were reached in the *Adams* case (5 T.C. 351 (1945) 331 U.S. 737), another recapitalization transaction case.

Now there could be no denial that the transactions in the *Bazley* and *Adams* cases were "recapitalizations" in the sense of ordinary speech, and that the statute contained no limitation on "recapitalization" to be recognized. True, the debentures issued in recapitalization might have been paid off later by the company, and if so, the proceeds received in "recapitalization" might have been treated as capital gains instead of as dividend income, but there was no evidence in either case that the "recapitalization" debentures could have been readily marketed or that the corporations did pay them or plan to pay them off.

As to the capital gain aspect, if the original corporations had been liquidated, the entire proceeds to shareholders over their investment would have been capital gain. Whether possible recovery of *part* of the investment through retirement of debentures was or was not to be treated as capital gain seems clearly a matter of legislative policy, not a matter to be settled by limitation read in by the courts.

Introduction by the courts of the idea that adequate "business purpose" is essential to an effective reorganization transaction left open the question of what constitutes a "business purpose," whose purpose governs, and how such purpose is to be proved. For a time the Tax Court followed the view that the purpose required could not be satisfied by a business purpose of the *stockholders* themselves, no matter how clear, but must be a business purpose of the *corporation* as a distinct entity. That view was challenged from the beginning by Judge Kern of the Court, who discerningly said:

> A realistic view of the ultimate purpose of a private corporation is that it is to make money for the investors . . . . and to distribute to them as much as possible and practical out of its gross income.

Judges Maris and Goodrich of the Circuit Court of Appeals of the Third Circuit (155 F. (2d) 237, 245 (1946)) succinctly stated that objection in dissent in the *Bazley* case, stating:

> A corporation does not have purposes apart from its shareholders. . . . If reorganization provisions contain too many avenues of escape for taxes . . . . Congress can close those avenues by appropriate legislation which can be so framed and defined as to leave the way clear. . . .

The Tax Court ultimately abandoned its view that the business purpose carrying exemption must be a business purpose of the corporation rather mystically distinguished from its shareholders. In deciding the *John B. Lewis* case (10 T.C. 1080 (1948)), the Court finally stated:

> To say that a corporation, as such, can have motives and purposes apart from its stockholders, the collective group of individuals who own it, is to indulge in metaphysical reasoning which has no proper place in such practical matters as taxation.

In spite of the change in the attitude of the Tax Court, uncertainty resulting from the *Gregory* decisions still remains. Whether the "business purpose" test or the "effect" test is read into the statute doubts assail the businessman and his lawyer contemplating important transactions under the statute.

It was to eliminate reorganization doubts that the Special Tax Study Committee, of which the Honorable Roswell Magill was Chairman, recommended to the Committee on Ways and Means:

> that section 112 be supplemented with a provision that no other conditions, requirements, or qualifications not specifically expressed in the foregoing section shall be applied, unless the Commissioner shall have established, by a clear preponderance of the evidence, that the principal purpose of the plan of reorganization is to defeat or to avoid the income taxes imposed by Chapter 1 of the Code.

Such a provision would be novel, but insufficient. The qualification would still leave the doubt as to what constitutes a "principle purpose." The only cure is the "meticulously drafted" statute and adherence to it by the courts.

Loss—the Higgins Departure

The *Higgins* v. *Smith* decision of the Supreme Court in 1940 (308 U.S. 473), dealing with certain losses, presents a notable case of reading into the statute a provision not there. In 1932 the taxpayer sold to a corporation, the stock of which was owned by him, securities which had depreciated in market value much below their cost to him. There was no question of the fairness of the sale price to the corporation, but the Treasury disallowed the loss on the ground that there had been no real disposition of the shares by him.

In the case of shares sold by a taxpayer to similarly owned corporations at a *profit* the Treasury had always asserted tax, as it does today. Four Circuit Courts of Appeal had rejected the Treasury contention that losses in the case of such sales should be disallowed. The Treasury had urged Congress to amend the statute, and the result was the adoption in the Revenue Act of 1934 of Section 24(a) (6) authorizing such disallowance. That act expressly provided, however, that

> The provisions of this title shall apply only to taxable years beginning after December 31, 1933. Income . . . . taxes for taxable years beginning prior to January 1, 1934, shall not be affected by the provisions of this title but shall remain subject to the applicable provisions of prior revenue Acts.

The Supreme Court sustained the disallowance of the loss in this case on the ground that since 1930 the Treasury had been urging such a position. The disregard by the Court of the statute itself and of established judicial interpretations aroused Justice Roberts to vigorous protest. In his dissent he said:

> I am of opinion that where taxpayers have relied upon a long unvarying series of decisions construing and applying a statute, the only appropriate method to change the rights of the taxpayers is to go to Congress for legislation. . . . The action taken in this case seems to me to make it impossible for a citizen safely to conduct his affairs in reliance upon any settled body of court decisions.

He might have added "or statutory wording."

Whose Income? The Clifford Departure

The much discussed *Clifford* decision of 1940 (309 U.S. 331) is based upon a departure from the statute as to who pays the tax on income. The statute makes specific provision as to cases in which some one other than the legal owner of income is held for the tax upon that income. In the *Clifford* decision the tax was held to reach one not the legal owner, in a case not provided for in the statute, with resulting confusion ever since.

The income in question was that of a trust created under the laws of Minnesota, under which the wife of the grantor was the income beneficiary. The decision was that notwithstanding the wife's legal ownership of the income, the income should be taxed to the grantor.

The Clifford trust was to continue for five years unless earlier terminated by death of the grantor or his wife. The income was to be paid to the wife not later than the termination of the trust, but on the termination the principal of the trust was to be paid over to the grantor. The grantor was trustee and retained broad powers as to management and investment.

The Commissioner taxed the income to the grantor, asserting tax liability in the amount of $2,756. The Supreme Court, in sustaining the Treasury, relied upon Section 22(a) of the statute (Revenue Act of 1934) but that section merely defines gross income and contains nothing as to treating income as other than the income of the legal owner. The Court stated that the issue was "whether the grantor after the trust has been established may still be treated, under this statutory scheme, as the owner of the corpus," saying:

> In absence of more precise standards or guides supplied by statute or appropriate regulations, the answer to that question must depend on an analysis of the terms of the trust and all the circumstances attendant on its creation and operation.

The Court rested its decision to disregard *legal* ownership as the basis of tax upon the combination of three factors: the

short term of the trust, the beneficiary being a member of the grantor's family, and the retention of broad powers of management by the grantor.

The Treasury has since pressed the taxability of trusts on the ground of any one of the above factors, and has asserted liability of grantors of trusts where there is a reversion within the period of ten years or, if management powers are reserved, a reversion within fifteen years.

The result has been ceaseless confusion on the subject. A first attempt at clarification was made by the Treasury in T.D. 5488 of 1945, and a second in T.D. 5567 of 1947.

Notwithstanding these efforts, it remains impossible to predict with reasonable accuracy the income tax status of many trusts. In scores of decisions the lower courts have grappled with the problems, and deficiencies proposed by the Commissioner are today awaiting trial on which the grantor is charged with tax liability far in excess of his own income and any of the trust income which may be made available to him.

In making its decision in the *Clifford* case, the Supreme Court was of course activated by the wish to have the tax law reflect the Court's conviction as to the right result in the case before it. Yet Congress, author of the tax law, had in its own way dealt with the problem before the Court. Code Sections 166 and 177, then in force, enacted as Section 219 of the Revenue Act of 1924, provided for the taxation of trust income to the grantor under certain carefully specified conditions. In 1934, however, Congress had rejected Treasury recommendations for the inclusion of a provision specifically taxing to the grantor income of short term trusts. The Court in supplying such provision, necessarily vague in its application, was taking over the function of Congress.

That view was expressed by Justice Roberts in his dissenting opinion as follows:

If judges were members of the legislature they might well vote to amend the act so as to tax such income in order to frustrate avoidance of tax but, as

judges, they exercise a very different function. They ought to read the act to cover nothing more than Congress has specified.

Adherence to the Statute

In theory, the judges generally recognize that it is their function to apply the words of the statute enacted by Congress in the manner indicated by Justice Roberts, so as not to add to or subtract from them according to their views as to the desirable results. Justice Frankfurter has said:

> .... where policy is expressed by the primary lawmaking agency in a democracy, that is by the legislature, judges must respect such expressions by adding to or subtracting from the explicit terms which the lawmakers used no more than is called for by the shorthand nature of language.[1]

Perhaps it is in the "shorthand nature" of language that justification is found in practice for wide departure from what seem to be the explicit terms of the statute, and denial of what the Supreme Court once referred to as a "literal interpretation dogma which withholds from the courts available information for reaching a correct conclusion."

In the *Gregory* case, Judge Hand put the basis of free interpretation as follows (69 F. (2d) 809, 810):

> .... the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create.

How great has been the tendency of recent years for courts to depart from adherence to statutory language has been strikingly put by Justice Jackson, who has said:

> The custom of remaking statutes to fit their histories has gone so far that a formal act, read three times and voted on by Congress and approved by the President, is no longer a safe basis on which a lawyer may advise his client, or a lower Court decide a case. This has very practical consequences to the profession. The lawyer must consult all of the committee reports on the bill, and on all its antecedents, and all that its supporters and opponents said in debate, and then predict what part of the conflicting views will likely appeal to a majority of the Court. Only the lawyers of the capital or

[1] "Some Reflections on Reading of Statutes," lecture before Association of the Bar of New York City, March 18, 1947.

the most prosperous offices in the large cities can have all the necessary legislative material available. The average law office cannot afford to collect, house and index all this material. Its use by the Court puts knowledge of the law practically out of reach of all except the Government and a few law offices.[2]

With taxation such a vital factor as it is today to business planning, it is of great importance that advance determination can be made of the tax effect of proposed transactions. The Treasury has a stake in that predictability, perhaps as great as that of the taxpayer, for in the long run what yields most revenue is smooth and orderly transaction of business. There is little justification for the assumption that Congress will always assert maximum tax liabilities. Concessions in taxation may be as advisable as concessions in prices.

Instead of judicial law-making in dealing with tax statutes, dependable rules of construction should be utilized to ease the burdens on the courts and the mind of the taxpayer. These rules should include the simple canons, once widely favored, that the statute must be taken as it stands without addition or subtraction; that where the statute is unambiguous the courts cannot seek elsewhere for legislative intent; that the courts cannot change the meaning by supplying omissions or inserting something not already in the statute. The use of elaborate consideration of legislative history, even if not entirely excluded as it is in England, should weigh little against the actual wording of the statute.

Danger that the Revenue Code will be unduly expanded by express provisions setting doubts at rest is nothing to the uncertainty that without such provisions the taxpayer must be left to wander dazed through an ever expanding multitude of court decisions.

Return to Congressional statutes can be obtained only if the courts have a change of attitude. It is a striking part of judicial history that the judges of the Supreme Court did experience such a change as to the interpretation of constitutional

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[2] *American Bar Association Journal,* XXXIV, 535, 538.

limitations—the notable change of the latter thirties and the early forties, which so largely freed the legislative power of Congress.

It is strange that at the very time when the High Court was freeing Congress from limiting constitutional interpretations, it was limiting the legislative power by wide extension of statutory interpretation.

As part of the change on the Court on constitutional limitations, the power of administrative tribunals was recognized as expanded, this for the reason that in view of the complexity of the subjects of regulation detailed rules can best be formulated by experts. Tax legislation pre-eminently demands fashioning by experts. Those responsible for the formulation of legislation must have before them the broad consequences of provisions, which the courts looking at the effect of a particular case only can hardly take into account. An implied limitation upon statutory language which may appeal to the court as desirable in a particular case to accomplish a desired result, if applied in other cases not then before the court, may defeat the legislative purpose.

As in the thirties the call to the court was "back to the Constitution," the call must now be "back to the statute." Left free, Congress is likely to be more alive to its primary responsibility and more careful in draftsmanship. Confined to the statute, the Treasury will be more predictable in administration.

If courts refrain from legislating they will still have ample function in seeing that neither the Treasury nor the taxpayer is mistreated under the statute. What is essential is that Congress be left to write the law and that the Treasury be subject to review in its enforcement. Some day the vigorous dissents by Justice Roberts in favor of adherence to the statute may come to be as highly regarded as dissents of Justice Holmes favoring adherence to the language of the Constitution.

Tax administration will remain confusing until tax statutes are clear and the courts give them firm adherence. From the courts we now need stress on fidelity rather than on philosophy.

PART THREE

FEDERAL INCOME TAX ADMINISTRATION: BUREAU-TAXPAYER RELATIONS

CHAPTER VI

ADVOCACY AND OBJECTIVITY IN TAX ADMINISTRATION

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THE TAX SYSTEM of today taps the incomes and resources of the great majority of citizens in a direct and obvious fashion. In the federal system, the broad-based personal income levy brings an awareness of the cost of federal services to others than distillers, tobacco manufacturers, corporations, and the rich. As state tax systems have been diversified and extended, notably by the adoption of sales taxes, their impact has spread over a larger and larger portion of the citizenry. This has stimulated an increasing interest in recognizing the need for greater uniformity in the treatment of similarly circumstanced taxpayers. Both the broadened base of the tax system and the level of current tax rates have been factors which should evoke in administrators an awareness of larger responsibilities than "protecting the revenue."

DESIRABILITY OF OBJECTIVITY MORE OBVIOUS AS TAX BASE BROADENS

It may not be an entirely valid conclusion that objectivity in tax administration implicitly is regarded as essential only when the tax system has a universal application—or conversely that objectivity is unimportant, except theoretically, in the taxation of a few selected classes of individuals or commodities. Perhaps it suffices to note some tendencies. For example, one will find less crusading zeal for objectivity in the determination

of liquor taxes than for the correct determination of a tax on salaries and wages. Logically, the two issues stand upon similar ground, but most persons are inclined to dismiss an over-assessment of taxes on spirits as being comparatively unimportant—it is of consequence only to traffickers in and consumers of a product which is popularly supposed to give rise to more social, economic, and ethical problems than it mitigates. Quite a different attitude is displayed toward a tax paid by millions of citizens, especially if it is known directly to affect personal standards of living and consumption.

As federal and state revenue systems have come to depend more and more on broad tax bases, there has been a growing awareness among tax administrators that attaining objectivity in tax determination is far more than a theoretical or academic issue. In a system markedly dependent upon self-assessment and the cooperation of millions of taxpayers, a reputation for uniformity of treatment and equal attention to overages and deficiencies is indispensable to good administration. Thus, the processes of verification must be fully as concerned with protecting the interests of taxpayers as they have been with protecting the interests of the government.

Among those who seem to be moved by a desire to attain objectivity in tax determination, perhaps out of a regard for the comfortable feeling of alignment with the forces of virtue, opinion divides on a choice between the spirit and the letter of the statute. Indeed, some practitioners and administrators select one or the other as a particular situation seems to require. This inconsistency, together with practical considerations, impels other persons to regard objectivity in tax administration as a will-o'-the-wisp, unattainable to any significant degree. Do these realists correctly appraise the significance of the obstacles to uniformity? At the least we may credit them with a realization that objectivity is more than a slogan and can be attained only at the sacrifice of many well-established prerogatives.

To What Extent Can Objectivity Be Substituted for Advocacy?

To what extent is it likely that we can substitute objectivity for advocacy in tax administration? We have long been accustomed to determining tax liability by the weighing of pros and cons. We assume the taxpayer or his representative acting in self-interest is of necessity an advocate of the lowest possible tax. The administrator is almost automatically thrown into a contrasting role—that of the government's advocate. From the vivid hues painted at extreme points of view, one advocate, the tax administrator, has to give the shade of objectivity to the result. Psychologically, this may be an impossibility. The zeal of the administrator in defense of the government almost inevitably affects the dispassionate judgment on his and the taxpayer's arguments.

Is the approach of the scientist available? That is, instead of relying on contending advocates, can we correctly determine tax liability by eliminating all types of bias from the investigation and assimilation of the facts? Can we create the organization and environment for tax determination comparable to a well-equipped and adequately staffed laboratory? In the millennium some such method of determining each individual's tax contribution would certainly be employed. In the interim, the practical question is, how far it is possible to utilize and harmonize the training and points of view of taxpayers and their representatives with those of the tax administrator and his representatives so as to attain a reasonably uniform treatment for similarly circumstanced taxpayers.

Put in these terms, prospects are not particularly encouraging. The objective of the taxpayer and persons whom he hires to help him in tax matters would have to be not the lowest possible tax liability but the correct one under existing law. From the government's point of view the revenuers would have to forego the goal of the greatest possible yield from the tax system for a higher allegiance—an equal regard for the correc-

tion of all kinds of errors in tax determination, regardless of sign.

As between these opposing forces, it seems to me practicable to move more rapidly toward greater objectivity in the realm of government participation. That is to say, that the revenue agent and the deputy collector can be indoctrinated to regard the size of the tax as a secondary consideration much more easily than the taxpayer can be persuaded to a similar detachment. If the fact would encourage the taxpayer to higher levels of self-abnegation, it might even be possible to push the criterion for judgment to the point where the administrator would treat the financial interest of the government as secondary to the financial interest of the individual taxpayer, in short, to give the taxpayer the benefit of the doubt. Viewing taxpayers realistically, it is difficult to visualize even this concession securing anything like the universal adoption on their part of the criterion of correct tax rather than minimum tax. The collective conscience expressed in the government's representation can adhere to higher standards of integrity than many individual consciences, no matter what the average level of morality may be.

Another important aspect of the problem is that taxpayers are ordinarily looking at single isolated cases through an intimate knowledge of specific facts, but with no over-all appreciation of comparable situations experienced by other taxpayers. The intensity of their convictions, under partially apprehended conditions, that injustice is being done constantly spurs many to regard their relationship with the tax collector as being in a special ethical category. Some chiseling on tax liabilities is like cheating any impersonal gargantua, be it the federal government, a railroad, or a public utility company.

Thus, it must be recognized that creating a climate of confidence on the part of the taxpayer in the fair-mindedness of his government in dealing with his personal tax problem is a process of meticulous attention to individual cases by competent personnel over a period of considerable time. It requires

a well-drafted tax statute comparatively devoid of loopholes or discriminations, and a consistency of policy such that citizens can base their confidence in the government's attitude toward tax obligations on grounds of well-established precedent.

Tax Avoidance Constitutes Major Difficulty

The obvious cases of non-uniformity in tax treatment do not illustrate the real stumbling block, in the long run, to greater objectivity in tax determination. Basically, the difficulty is one of tax avoidance. It arises from the efforts on the part of the taxpayer, on the one hand, to alter the form of his taxable transactions so as to make them nontaxable, and the efforts on the part of the tax administrator, on the other hand, to thwart such tax avoidance. Administrators contend that their conduct is required to maintain uniformity in the treatment of similarly situated taxpayers if the spirit of the law is observed and if the position of the nonavoidance-minded taxpayers is to be protected.

This basic conflict probably can never be resolved but the arena in which it goes on can be limited by improved draftsmanship on the tax laws, with particular attention to eliminating loopholes for avoidance on the one hand and inadvertent or deliberate discrimination against particular taxpayers on the other.

The tax law has become so complicated that specialized attention to its applications has made it possible for specialists in accounting and tax law to provide services which will minimize legal tax obligations. The planning of business operations with tax effects as one of the major policy determinants has become common. Indeed, angles in the tax law have made it nearly imperative that the business or corporate official responsible for financial management must have tax counsel simply to protect him from arbitrariness in the tax law. Why not then employ the same counsel to take advantage of loopholes? It is highly questionable that anyone other than the tax practitioners derives any particular benefit from this arrange-

ment. Proposals to minimize the deficiencies in tax statutes which create these conditions inevitably require testimony from the persons who have the most at stake in perpetuating or adding to the difficulty. We can credit the legal and accounting profession with giving straight and untainted answers to specific questions but one can hardly expect that the ethics of any profession require that it liquidate its existence either in the short run or the long run.

More Reliance on Reforms Suggested by Administrators

So, I think the remedy to the marked advocacy in taxpayer presentations along these lines lies in more reliance on the reforms suggested by the tax administrator who sees the problem in far broader terms than any individual practitioner can ever see it: as the contrast between the small and the large taxpayer, the ignorant and the intelligent, the careless and the precise, and the well-represented and the unrepresented taxpayer.

The testimony of the administrator as to the shortcomings of the law in action and with respect to uniformity in application deserves far more attention than it has received. Unfortunately, few tax administrators have been good lobbyists for reforms. Lawmakers are not ordinarily equipped to initiate such proposals. Plugging up technical loopholes and eliminating discrimination has a notable lack of appeal to any except technicians in the field, and their attitude is one that anyone could be expected to hold toward his principal stock in trade. Major responsibility rests therefore with the administrator. If he strongly resists a particular type of avoidance on the ground of non-uniformity, his actions should lead to early legislative action or court test. If he does not provide a strong enough case for remedial action by one of these agencies, and still persists in using his authority to deny this particular type of avoidance, he is cultivating an environment in which objectivity can never be achieved.

CHAPTER VII

RELATIONS BETWEEN TAXPAYERS AND FIELD AGENTS

ARTHUR WM. WIENER

Office of the Internal Revenue Agent in Charge, Upper New York Division *

THE PROPER relations between taxpayers and field agents in federal income tax administration are largely a matter of personal opinion; but, some discussion of the atmosphere and procedure involved should be of general interest and help.

Field agents are internal revenue agents, often called "examining officers" or "auditors," and sometimes less complimentary names. These men—a few women are field agents—are attached to a field office, called an office of the internal revenue agent in charge or agent's office. Thirty-nine such field offices are in the Income Tax Unit of the Bureau of Internal Revenue of the Treasury Department.

An agent's office does not compute interest, collect taxes, pay refunds, distribute tax forms, or accept returns for filing, all of which are functions of a collector's office. The work of an agent's office is essentially the investigation of tax returns to determine correct tax liability. For various reasons, this work generates tax issues, most of which are readily settled by the internal revenue agents.

THE TAX RETURN

The preparation of the income tax return has a direct bearing on relations between taxpayers and field agents. Failure to

* The views expressed herein are entirely those of the writer, and should not necessarily be construed as the official opinion of the Bureau of Internal Revenue.

file the return is not the best method of avoiding the relationship. Careful preparation of the return may, however, result in its acceptance as filed without an examination at any of the several cursory inspections, called "surveys," made before assignment of a return for investigation. Obviously, many returns must and can be accepted without an examination.

Furthermore, complete and accurate preparation with full explanation of significant items aids in accomplishing the taxpayer's desired psychological effect on the agent. He may then conduct a less extensive examination and write a so-called "partial" report with no revision in tax liability. His thorough examination could result in a "no change" report.

To omit detailed schedules or to make mathematical mistakes is to invite an examination. Unusual items or transactions should be fully explained with the return as such information may avoid a question being raised as to negligence and tax evasion. Additional taxes, interest charges, embarrassing refunds, and penalties are caused by improper preparation of the tax return.

Relations During the Audit

The field agent is the finder of the facts that are basic for a determination of correct tax liability. Taxpayer, tax man, and agent simply must work together to discover the facts required.

Cooperation

The relationship of taxpayer to agent during the audit should be one of full cooperation, which is sensible, because the agent has almost irresistible powers to get the information he needs. Relations invariably tend to be polite, businesslike, and, outwardly at least, very pleasant. Of course, if an agent is antagonized, he may forget the customary objective attitude and become unduly concerned about the tax liability of the taxpayer.

It should be clearly understood that a field agent's primary

concern is to complete examinations, called "production." He receives no credit whatsoever for setting up tax deficiencies or denying refunds. Unfortunately, it seems to be humanly impossible for taxpayers, because of their important personal interests in their cases, to be as objective as field agents.

The agent should be provided with a quiet and agreeable place to work and with all the necessary books and records of the taxpayer. The tax work papers used in the preparation of the return are extremely useful to the agent, shorten the time required for the audit, and naturally help the taxpayer's relations with him.

Audit Program

No fixed audit program guides the agent. He relies on his experience and judgment. Anything significant or substantial in the return or records will prompt questions. Prepared analyses of such items or accounts are helpful. Voluminous transactions are generally test checked. Certain items are likely to be examined such as: traveling and entertainment expenses; officers' salaries; repair accounts; depreciation schedules; journal entries; sales or exchanges of assets; pension and profit-sharing plans; legal and professional expenses; and the applicability of Section 102. The "proof" an agent seeks is consistent, tangible evidence such as cancelled checks, brokers' statements, receipted bills, and book entries contemporaneous with the transactions.

Agreed Cases

When the audit is ended, the agent may have a number of changes affecting tax liability. If his findings are substantially correct, the taxpayer should evidence his agreement by execution of Form 870, called "Waiver of Restrictions on Assessment and Collection of Deficiency in Tax." (Similar forms are used when the audit results in an indicated refund.) The agreement simplifies and expedites relations with the taxpayer because no ninety-day letter is required, and the collector may assess the

tax upon receipt of a copy of the revenue agent's report. The "870" does not say the tax is correct and is not a closing agreement. The taxpayer may later file claims for refund, and the Bureau may later make additional assessments. The advantages of the agreement to the taxpayer at this stage include (1) the elimination of the time and effort of filing a protest and subsequently negotiating with a conferee; (2) interest stops thirty days after receipt of the agreement; and, (3) tax uncertainty is practically removed for the case is probably closed although it must be post-reviewed. Possible disadvantages include (1) earlier payment of the tax, and, (2) waiver of the right to petition the Tax Court.

Extension of Statute of Limitations

Another agreement frequently employed is Form 872, called "Consent Fixing Period of Limitation Upon Assessment of Income and Profits Tax." Beginning about ninety days before the statute of limitations tolls, this waiver is requested by a field agent or conferee to extend the statute where such action is necessary to protect both the taxpayer and the government. The agreement generally gives the taxpayer six months more time to claim a refund than the government gets to assess a deficiency. Although the signing of these consents is optional, taxpayers should execute them to allow a tax return to be audited, reviewed, and post-reviewed in the routine manner. Otherwise, the Bureau-taxpayer relations become unnecessarily strained by the issuance of a ninety-day letter based on the meager facts available and designed to protect the interests of the government and other taxpayers in general.

The agent's office also protects the interests of specific taxpayers by a standard procedure of inviting the filing of claims for refund wherever they are indicated.

Unagreed Cases

Unagreed field cases result in mailing the taxpayer a preliminary notice or thirty-day letter, including the report of the

field agent's findings. The taxpayer may then file a protest and request a formal conference with a conferee. The taxpayer may have an informal conference with the field agent's immediate superior, called the "Group Chief," before the thirty-day letter is issued. Probably the most effective use of the informal conference is to enable the taxpayer or his representative to discuss items in controversy which may be cleared without the necessity of filing a formal protest.

Disagreements in most cases are fundamentally avoidable. Proposed adjustments of fact questions, like officers' salaries or traveling and entertaining expenses, theoretically should not necessitate a protest. But in too many cases, the facts are not really presented until after the opportunity has passed for the earlier and easier closing of the case with the field agent.

Review

Every revenue agent's report, written by the field agent, goes to the review section of the agent's office for technical review by experienced agents, called "reviewers." This is not the audit review or post-review, which is made later in Washington.

Taxpayers have no direct relations with reviewing agents. If a reviewer directs a change in the report, such as the raising of a new issue, the field agent discusses the matter with the taxpayer. The reviewer's ideas may control at this stage. The reversal of the reviewer may be accomplished by filing a protest on receipt of the thirty-day letter; for, at the formal conference, the conferee can overrule the reviewer.

By far the largest number of cases are turned back by the review section to the field agent, and therefore to the taxpayer, because of insufficient facts for an adequate report. Complete facts to the agent, particularly for the large and important items, will facilitate quick disposition through review.

The Protest

The relations between the taxpayer and the personnel of the agent's office are continued by the taxpayer's submission of a

protest to the field agent's findings within the thirty days usually allowed by the preliminary notice or thirty-day letter. An agreement on Form 870 for the tax proposed may also be signed during these thirty days. A short written request stating a reason for extension of the time for filing the protest ordinarily receives favorable consideration.

Procedure in "Default" Cases

If no protest is filed and no Form 870 is executed, the case is called a "default" case. A ninety-day letter, or deficiency letter, is then written by a conferee and sent by the internal revenue agent in charge by registered mail to the taxpayer to end the relations between the taxpayer and the field agent's office. The ninety-day letter is the notice required by law before the Commissioner may assess a deficiency, unless this requirement has been waived by the signing of Form 870. On receipt of the ninety-day letter, the usual alternative procedures available to the taxpayer are (1) filing a petition with the Tax Court within ninety days, or, (2) payment of the tax followed by a claim and suit for refund in a District Court or in the Court of Claims. Of course, the taxpayer may simply give up and pay the tax immediately or pay it later on demand made by the local collector of internal revenue.

Form and Content

The requirements of form and content of a protest are set out in Mimeograph 3937. The protest should identify the case, be signed by the taxpayer under oath, contain a statement by the person preparing the protest, and be submitted in triplicate. The required contents include findings protested, grounds for taking exception, and request for oral hearing if desired.

Issues should be clearly and tersely stated. Attempts to trade hopeless or frivolous issues for meritorious ones rarely succeed, and, furthermore, do not help your relations with the conferee.

The facts are vital. It is probably a fair estimate that about 90 per cent of the issues in conference really concern factual

situations rather than legal disputes. "Get the facts!" is a slogan of field agents, reviewers, and conferees. The facts should be completely, accurately, and fairly stated.

Law, where necessary, should be cited correctly, briefly, and pertinently. The argument should be as persuasive as possible. A short discussion of the equities of the case, conceded to be legally irrelevant, may enlist the conferee's sympathetic consideration for an equitable settlement. A protest or brief should also contain a summary and conclusion.

Preparation of a thorough protest insures that the practitioner has mastered his case and provides an opportunity for skillful presentation of facts and arguments for the conferee's consideration.

Relations Involving Formal Conferences

The conferee, who is an internal revenue agent working in the conference section of the agent's office, sets a date for the formal conference. The field agent, the taxpayer, his representative, his employees, and his witnesses may all attend the conference. Some practitioners seem to have an aversion to taking their clients to conferences, but the presence of the taxpayer to give such facts as are peculiarly within his own knowledge generally expedites the settlement of the correct tax liability.

Informal Proceedings—Credentials Required

No rules of evidence or legal procedure hamper the presentation of facts or arguments at the informal proceedings of a conference. However, three formalities or credentials are necessary for a practitioner to represent a taxpayer. The taxpayer's representative must:

1. Submit a power of attorney in triplicate authorizing him to represent the taxpayer.
2. Produce his Treasury card or "Green Card" to prove his enrollment to practice before the Treasury Department.
3. Sign a fee statement stating whether his remuneration is on a fixed or contingent basis, and if contingent whether a copy of the fee arrangement has been submitted to the Committee on Practice in Washington for approval.

A good impression is made by strict adherence to these requirements published in Department Circular No. 230 (revised May 1947), and in the Bureau's statement of Conference and Practice Requirements (revised February 1942), 1942-1 C.B. 384. This statement is also published in the Federal Register at page 950 of Volume 12.

Conferee's Job and Attitude

The conferee's job is the settlement of cases. The conference procedure was instituted by the Bureau to aid in the disposition of cases without litigation. Having no pecuniary interest in the issues, the conferee has a duty to be fair and just. He really tries to perform the difficult task of being impartial to all taxpayers and the government. Actually, the facts and theory concern him more than the tax result, for he seeks a correct settlement.

The conferee as a Bureau employee is bound by a considerable body of law, regulations, cases, and rulings. The main problem, however, is the need for sufficient facts from the taxpayer for his case.

The settlement negotiations are not to be looked upon as an easy means of compromising tax liability. They do not consist of "splitting the difference." The settlements reached must be supported by facts and interpreted as being in reasonable compliance with applicable law.

As with the field agent, clashes of personalities must be carefully avoided if good Bureau-taxpayer relations are to prevail. An open-minded, reasonable, and sincere attitude toward the merits of both the tax issues and the persons in the case is advisable for all concerned.

Procedures After the Conference

If the taxpayer agrees with the conferee, a Form 870 should be executed to have the same effect as such an agreement to the field agent's findings. If agreement is not reached, a one-sentence request for referral to the technical staff may be signed

by the taxpayer or his representative. (The technical staff, which is not part of the agent's office, conducts informal hearings on protested and docketed cases.) Otherwise, in unagreed cases, the ninety-day letter is issued giving the taxpayer the usual procedural alternatives. The petition to the Tax Court after receipt of the ninety-day letter or the claim and suit for refund after payment of the disputed tax are still available to the taxpayer when no agreement is reached in the agent's office. In short, the taxpayer has access to further hearings or appeals if dissatisfied with the outcome of disputes with the agent's office.

The conferee's determinations are reviewed by other experienced conferees in the field office. The conferee's disposition of the case, like that of a field agent, is also subject to post-review in Washington.

In spite of all the limitations and problems of conference, between seventy-five and eighty per cent of protested cases are settled by the conference section.

Relations with Audit Review

The "post" or "audit" review referred to previously is the review in Washington of all income and excess profits tax cases closed in the agent's office (including the surveyed cases). One purpose is administration of the tax laws with national uniformity, an important element in achieving tax equity. If Audit Review reverses a field agent, he contacts the taxpayer and writes a supplemental report. As described earlier, his report goes through the review section; and, if not agreed to by the taxpayer, the thirty-day letter is issued, a protest may be received, and a formal conference held. According to a relatively new procedure, the taxpayer may then request another conference before the conferee in the agent's office with a qualified representative of the Deputy Commissioner attending. Dissatisfaction with the outcome of the requested conference still finds the taxpayer with the usual alternative procedures outside the agent's office.

Other Relations

A few of the several other relations between taxpayers and an agent's office will receive only limited treatment. Even a brief mention of other duties assigned to internal revenue agents should help to convey a more complete picture of the many problems involved in federal income tax administration.

Standard issues have been separated from Section 722 claims for excess profits tax relief since the Excess Profits Tax Council was created in Washington over two years ago to have technical supervision of Section 722 cases in the Bureau. A Section 722 field committee in the agent's office has technical supervision of the examination and settlement of these claims in the field. Administrative supervision is in the office of the internal revenue agent in charge.

The pension trust section in the agent's office studies submitted pension plans, amendment and termination proposals, holds conferences, and issues opinions thereon, all within the scope of the requirements of Section 165(a) of the Internal Revenue Code. The Section 23(p) deductions for contributions to pension and profit-sharing plans are reviewed by men in the review section of the agent's office. Strict compliance with the detailed Regulations 111 is extremely advisable in connection with all pension and profit-sharing plans.

Black market cases and the tax issues of fraud cases are developed in the agent's office, often in cooperation with the Special Intelligence Unit of the Bureau which, where necessary, makes the recommendations for criminal prosecution.

The valuation section in the agent's office considers such things as the amount of casualty losses, the relative value of land and building, and the basis for depreciation.

Summary

To summarize, complete facts from taxpayers are the most soothing balm for the taxpayer-field agent relationship. Incorrect procedures by tax men are not likely to foster the best

relations. Tax returns are investigated by men, not machines, so clashes of personalities must be avoided if relations are to remain reasonably objective. The presence of readily available appeal procedures prevents and corrects erroneous administration of the law.

The personnel of the agent's office, I think, participates in the administration of the tax laws in an atmosphere conducive to the achievement of tax equity. The success of the field agents and conferees is made apparent by the proportionately few appeals taken outside the agent's office.

Knowing the importance of the administration of the federal income tax in our lives and in the national economy, all of us may agree that tax men and field agents will have to live and work together for a long, long time. I wish you good luck and the best of Bureau-taxpayer relations!

CHAPTER VIII

RELATIONS BETWEEN TAXPAYERS AND COLLECTOR'S OFFICE

JAMES W. JOHNSON
Collector of Internal Revenue, Third New York Collection District

GOOD RELATIONS between the taxpayers and the collector's office are essential in establishing and maintaining good Bureau-taxpayer relations. This is especially true in view of the responsibility of the taxpayer to collect and pay over certain employment and miscellaneous taxes, and since the adoption of the device of withholding income tax on wages and salaries.

ADMINISTRATIVE OPERATIONS AND PROCEDURES

The initial draft of the report to the Joint Committee on Internal Revenue Taxation contains some charts describing in detail the various operations and procedures in administering the major taxes and groups of taxes.

Charts I to IV show that for the fiscal year ended June 30, 1947, in the sixty-four collection districts, the functions and operations relating to (1) income tax returns filed by individuals on Form 1040; (2) income tax returns filed by individuals on withholding statement (Form W-2); (3) employers' returns (Form W-1) of income withheld from employees; and (4) corporate income and excess profits, including work relating to exempt organizations, required the expenditure of 27,062,000 man-hours connected with servicing taxpayers compared with the expenditure of 25,948,000 man-hours connected with verification and enforcement activities.

Other charts show that for the same fiscal year, in the sixty-four collection districts, the functions and operations relating to (1) employment taxes, (2) estate and gift taxes, (3) alcohol taxes, and (4) other miscellaneous taxes, required the expenditure of 5,358,000 man-hours connected with servicing taxpayers compared with the expenditure of 7,003,000 man-hours connected with verification and enforcement activities.

The taxpayer is in a much more pleasant and cooperative mood when the deputy supplies him with the proper form, assists him in filing a proper return, and answers his inquiries in regard to claims and refunds, than when the deputy contacts the taxpayer to secure a delinquent return, to investigate a lead regarding tax evasion, or to effect collection with a warrant for distraint.

The efficient servicing of taxpayers is one of the most important factors in good relations between the taxpayer and the collector's office. In many instances, the only contact which a taxpayer has with the Bureau of Internal Revenue is through the headquarters or branch office of the collector of the district in which he resides or has his principal place of business. Over 60 per cent of the employees of the Bureau of Internal Revenue are in the offices of the sixty-four collectors of Internal Revenue.

Improvements in Operating Functions

The Bureau is constantly making improvements in operating functions in order to furnish taxpayers with all of the services required by them.

The withholding tax, employment tax, and miscellaneous tax divisions in the collectors' offices have been consolidated into a single division, designated the wage and excise tax division. The other tax unit in the collectors' offices is the income tax division which processes income tax returns of individuals filed on Form 1040, or 1040-A, and returns of partnerships, fiduciaries, and corporations.

Under the Bureau's mechanization program, key punch and

tabulating equipment has been installed in a number of areas to expedite the determining of the tax for taxpayers who file their returns on Form 1040-A and elect to have the collectors compute the tax for them. It is expected that the use of this equipment can be extended to the processing of declarations of estimated tax filed on Form 1040-ES, and other types of returns.

It is possible now to use depositary receipts in connection with the payment of income taxes withheld from wages up to the last day of the quarterly filing period for which the return is due. It has been suggested that the depositary receipt method of making payments be extended to employment and miscellaneous taxes.

In one of the collection districts, the Bureau is testing a new tax form combining the return of income tax withheld on wages (Form W-1) and the employers tax return under the Federal Insurance Contributions Act (Form SS-1a). Should this form be adopted generally, the employers would be able to pay both these taxes with one check, sign one affidavit, and retain one copy of the combined form in their files.

In order to facilitate the mailing of blank forms, the Bureau is making a study of the practicability of using inserting and mailing machines in the collectors' offices.

Special classes are being conducted to prepare zone deputy collectors to assist taxpayers in the preparing of timely and accurate returns. This practice is in line with the policy of protecting the interest of the taxpayer and improves the Bureau-taxpayer relations.

The improved Forms 1040 for 1948 and the pamphlet of official instructions are a great help to the taxpayer in the determination of his correct income tax liability. A more detailed publication is a booklet entitled "Your Federal Income Tax" which can be obtained for twenty-five cents from the Superintendent of Documents, Government Printing Office, Washington 25, D. C. If the taxpayer meets certain require-

ments he can answer a few simple questions on Form 1040-A and have the collector compute his tax liability.

It is believed that from the studies, examinations, inspections, audits, and surveys being conducted by groups inside and outside the Bureau of Internal Revenue, improvements in operating functions will result to the benefit of both the taxpayer and the government.

The collectors' offices are on the front line in servicing taxpayers and in the verification and enforcement activities of the Bureau. As the situation requires the collector must shift his forces between these important endeavors. To accomplish this mission, it is imperative that he, at all times, be mindful of the relations between the taxpayers and his office.

CHAPTER IX

RELATIONS BETWEEN TAXPAYERS AND CENTRAL ADMINISTRATION

CHARLES OLIPHANT
Chief Counsel, Bureau of Internal Revenue

TWENTY-FIVE YEARS ago the assignment of the topic "Relations Between Taxpayers and Central Administration" to a member of a symposium on tax administration would clearly have indicated that he was to play the leading role in the symposium. That is because in the early days of the federal income tax a large part of the administrative burden was carried in Washington. Fortunately for the taxpaying public, this feature of federal tax administration has undergone a radical change. The change has been rather consistent, if somewhat erratic. It has paralleled the increase in the number of taxpayers and in the over-all amount of their tax liability. These changes obviously necessitated a decentralization of administration in order both to meet the convenience of the taxpayer and to make the Bureau's task one which was possible of fulfillment. Today relatively little of the contact between the individual taxpayer and the Bureau need any longer take place in Washington, and consequently comparatively little remains of a once all-embracing subject.

A survey of the occasions on which specific taxpayers feel impelled to enter into direct relations with the Bureau in Washington, or vice versa, does reveal some pattern of powers reserved to the central administration. I can think of no single rule of thumb, however, by which one can distinguish between field and Bureau jurisdiction. Indeed, the only obvious ap-

proach to this subject is for me to refer to and briefly describe each of these occasions seriatim.

Closing Out Cases for Past Years

Of first and most ordinary interest to the majority of taxpayers are the occasions on which they see Bureau representatives in the course of closing out cases for past years. These occasions are limited in number and in scope. One such occasion arises whenever an internal revenue agent in charge having jurisdiction of a case decides that it involves an issue requiring technical advice from the Bureau. Before transmitting the case to Washington, with a request for advice, the agent is required to notify the taxpayer that he proposes to do so, and explain to him that a hearing will be granted in Washington in the event that an adverse decision is contemplated and that the taxpayer has indicated his desire for the conference. The taxpayer must also be permitted to submit a brief on the facts and law of the case which will be transmitted to Washington along with the agent's request.

Another occasion for direct contact arises in certain instances when Post Review in Washington disapproves a closing action which has been agreed to by the taxpayer and the internal revenue agent in charge. If the agent and the taxpayer are unable to reach an agreement based upon the advice received from Post Review, a representative of the Income Tax Unit will be dispatched from Washington to hold a field conference with the taxpayer's representative to explain the Bureau position and to hear the taxpayer's arguments with respect thereto.

Also, taxpayers have direct contact with Bureau representatives in connection with past years when they seek to close out past years through the statutory mechanisms of compromises or closing agreements. Compromises and closing agreements, which conclude legally binding determinations, are required by law to have the approval of the Commissioner and of the Secretary of the Treasury. In compliance with the spirit of the law, these instruments are reviewed by the Commissioner's and

the Secretary's closest advisers. In the course of their examination of proposed agreements, they are always readily accessible to taxpayers who wish to argue personally in favor of the agreements.

Prospective Rulings and Closing Agreements

Another major class of cases in which taxpayers and Bureau people have direct contact is that involving prospective rulings and closing agreements. This class differs from the one just discussed in that the subject matter of the present class comprises specific issues bearing on future years as distinguished from the total tax liability of past years. Prospective rulings and closing agreements have been made available to taxpayers on the notion that the tax implications of business and other financial transactions are now so significant that no one can intelligently plan his affairs without knowledge of the tax consequences. Accordingly, any taxpayer who asks the Commissioner's advice with regard to a real problem connected with his business or personal affairs will in most cases receive a statement of the Bureau position with respect thereto.

Although prospective rulings as distinguished from closing agreements are not legally binding on the Commissioner, it has long been the Commissioner's practice to honor such rulings in the case of a particular taxpayer to whom they are issued without regard to any subsequent change of administrative position. This is necessary in order that rulings may serve the purpose to which they are devoted. But a consequence of the finality of these rulings is that they must be prepared in Washington and reviewed on the highest levels. In the course of their preparation and review taxpayers have completely free access to the Bureau officials concerned. They are acquainted with the apparent difficulties involved in the issuance of the requested ruling and permitted to meet these difficulties with such evidence and arguments as they care to marshal.

PROMULGATION OF REGULATIONS

A third kind of occasion for direct contact arises in connection with the promulgation of regulations. As you know, regulations are issued by the Commissioner with the approval of the Secretary. They are actually prepared in the Bureau, frequently in the Chief Counsel's Office. The particular officials responsible for the preparation of regulations are constantly engaged in the study of current regulations with a view to correcting and improving them, as well as making the changes which are required by amendments to the Internal Revenue Code. In discharging this responsibility these officials are constantly entertaining proposals from interested taxpayers and groups of taxpayers for additions to, or other changes in, existing regulations.

These proposals are sometimes made through oral conferences and sometimes by means of carefully prepared written statements. In either event the Bureau representatives will give full consideration to the proposal and, to the extent that time and their other duties permit, will advise its proponents as to their attitude toward the wisdom and legality of it. Moreover, under the Administrative Procedure Act most regulations which contain substantive rules are published in tentative form in the Federal Register prior to formal adoption of regulations on the subject involved. Then a period of at least thirty days is given during which any interested persons may submit their views with respect to the proposed regulations to the Commissioner in writing. All such expressions will be considered before final promulgation of the regulations. Indeed it is the practice of the Bureau to respond to each such expression of view, indicating the action which has been taken and the reasons for doing so.

RELIEF AND REFUND CLAIMS

A fourth occasion for direct contact is when taxpayers come to Washington for hearings before the Excess Profits Tax

Council. These hearings follow upon the filing of claims for relief under Section 722. Every determination made by the Section 722 committee in the office of each of the internal revenue agents in charge is reviewed by the Council. The Council regularly grants hearings to claimants and affords them an adequate opportunity to submit additional evidence and to enlarge upon their arguments.

Claims for refunds based on standard issues in both the income and excess profits taxes also may bring taxpayers to Washington conferences. If the Bureau proposes to allow a refund in the amount of $75,000 or greater, the law requires the Joint Committee on Internal Revenue Taxation of the United States Congress to be so advised at least thirty days before the refund is made. All these cases are reviewed in the Chief Counsel's Office before they are submitted to the Joint Committee. At this stage taxpayers are welcome to consult with the review division of my office through conferences or otherwise.

Criminal Fraud Problems

Finally, we pass from civil to criminal problems. In this area, the established procedures of the Bureau provide that prosecution shall not be recommended in any case until it has been reviewed in the Chief Counsel's Office in Washington. This review, added to the regular review accorded penal cases in the field, is calculated to insure that fraud prosecutions are not brought without a sound basis for them having been established. Here, too, we are glad to accord taxpayers every reasonable opportunity to discuss their cases.

Trend Toward Decentralization

It seems to me that there is one generalization which can fairly and properly be made on the basis of the history and the present status of federal tax administration. This is that there has long been and still is a decided trend toward the greatest possible decentralization of administration. In my opinion the

ideal situation will have been achieved when no taxpayer need recur to Washington for a determination of his case and when the Washington office exercises only general supervisory powers over responsible operational field offices.

Conclusion

In conclusion, I do want to make the point that, contrary to what is sometimes said to be the fact, there are no substantial areas of secrets which indicate devious paths between the central administration and the field entirely to the exclusion of the taxpayer. We try to give cordial and complete opportunity to be heard and often call upon the wisdom of outside experience before reaching conclusions. In general, everybody knows what is going on at all times, and rightly so. There are, of course, some exceptions such as in criminal action cases, or in some phases of policy questions where a wise administration of the law indicates that confidential relations are necessary. In general, however, and to repeat, I believe that we try to meet all taxpayers cordially and in the open, with a full, frank discussion of the myriad problems that make up the day-to-day practice of the tax law. It may be that our system works as well as it does just for this reason.

CHAPTER X

CANADIAN EXPERIENCE IN DECENTRALIZATION OF ADMINISTRATION

A. H. Rowland

Director-General, Montreal District, Taxation Division, Department of National Revenue, Canada

THE INCOME TAX in Canada—other than a limited provincial levy—stems directly from Canada's participation in the First World War. In 1917, the Canadian Parliament passed an Income War Tax Act, and those coming within its provisions were required to make returns early in 1918 in respect of their 1917 incomes.

Earlier in the war years, there had been enacted the Business Profits War Tax Act, which apart from its importance as a revenue-producing measure, is also significant—with some taxes on special classifications of taxpayers—as the first major direct taxation imposed by the federal government. To administer the business profits war tax, there had been created in Ottawa a small audit and administrative staff, and appointments had been made in the principal commercial centers of auditors, who carried out such investigations of business profits taxpayers' records as they were instructed by the Head Office to make. When the income tax became operative, the staff hitherto exclusively employed on the business profits tax took over income tax administration; the staff was increased; district offices were opened from coast to coast; and the two acts were jointly administered until the business profits war tax expired, and work thereunder was thereafter completed.

The arrangements thus made have in fact persisted, in main

outline elaborated in detail, down the years. At this time, we have a Head Office in Ottawa and twenty-one district offices. This persistence, it is suggested, is an indication that the arrangements meet both the requirements of taxpayers and of the administration, and that in circumstances of which their originators, and the taxpayers of the time, could have had no vision. At the time of its introduction in Canada, the income tax, even with high exemptions and low rates, was generally regarded as a purely temporary expedient, which would be abolished within a few years. It had to justify itself by persistent productiveness of revenue, before it was generally accepted as a permanent feature of the Canadian fiscal structure. In the years of the Second War, with low exemptions, steeply graded rates of taxation, a new and severe Excess Profits Act, and deductions at source, the income tax rapidly became a main prop of Canada's war revenues, which permitted a relatively high percentage of Canada's war expenditures to be met on a current basis.

In Canada, decentralization in income tax administration begins at the top. Budgeting and governmental taxation policy are in the charge of the Ministry of Finance; the administration of tax legislation lies with a department headed by the Minister of National Revenue. The Ministry of National Revenue has in turn two main divisions, each headed by a Deputy-Minister (the general title of our ranking departmental civil servants in Canada): Customs and Excise (with which we have nothing to do on this occasion); and Taxation, which administers the income tax, the Dominion succession duties—introduced in 1941—and for the time being, the Excess Profits Act, a war measure which expired in December, 1947. The Deputy-Minister is responsible directly to the Minister of National Revenue. The Minister, under our Canadian system of government, must answer in Parliament for the income tax administration, which is carried out in his name.

At the Head Office with immediate responsibility to the Deputy-Minister are senior officers: a Coordinator and Chair-

man of the Executive; the Director-General, Legal Branch; Director-General, Corporation Assessing; Director-General, Individual Assessing; Director, Administration; Director, Personnel; Administrator, Succession Duties Branch; and others. Their titles are descriptive of duties and functions in general direction, control, and guidance. Instead of elaborating upon these, however, it is convenient for the purpose of this paper, to proceed to the organization and functions of the district offices, and then develop their relationship to the Head Office.

District Offices

The district offices are scattered from Sydney, Cape Breton, to the Yukon. Three of the largest, Montreal, Toronto, and Vancouver, have at their head senior officers with the rank of Directors-General; the heads of other district offices have the rank of Directors.

The distinguishing feature of these district offices is that, subject to the instructions and directives of the Head Office, each district office is responsible for the whole of the income tax work within its area, both field work and office work. This naturally involves large staffs, ranging in character from highly trained technical men to stenographers and women clerks. Our largest district office has a staff establishment of 2,400, the second largest, over 2,000; the others range in size according to the importance taxwise of the area within their control, down to the smallest offices which range from 100 to 200 in staff.

In describing in this paper the organization and functions of a typical large district office, it will be realized that there are some variations, because of variations in the type of taxpayers principally dealt with, and in the smaller offices, some simplification. The general type is, however, uniform.

The work of the district office falls into three principal divisions, each in charge of a senior officer reporting immediately to the Director. These divisions are as follows:

1. Investigation and assessing of corporation returns.
2. Investigation and assessing of individuals' returns.
3. Administrative, clerical, and routine work.

It will be convenient to take these in order.

Corporation Assessing

This unit comprises a senior staff of accountants, a staff of trained assistants, and the appropriate clerical staff for the maintenance of files, tax rolls, and records, so that in effect, within the district office, this unit is practically self-contained.

The unit is subdivided into classifications such as manufacturing, merchandising, public utilities, primary industries, etc., so that over a period men become specialists in their work of investigation at taxpayers' offices, which is carried out on a team basis, somewhat similar to that used in professional accounting offices.

During the war years and subsequently this unit has naturally been largely engaged in making assessments under the Excess Profits Act. This unit also establishes the tax due by corporations to the governments of seven of the provinces and the Yukon Territory, with whom arrangements to this end have been made. The other two provinces collect their corporation taxes by their own organizations.

This corporation unit carries its work up to the point where proposed assessments with full reports indicating the scope of the investigation made and reasons for the findings, are sent to the Head Office in Ottawa, where they are reviewed by the staff of the Director-General, Corporation Assessing. If approved, they are returned to the district office for the sending out of the notices of assessment to the taxpayers; if disagreed with, there may be correspondence. In practice, in the great majority of cases, the Head Office accepts the findings of the district offices.

It will be observed that the Director-General, Corporations, at the Head Office, who has immediate responsibility to the

Deputy-Minister for Corporation Assessing, keeps control of it, through his Head Office staff and through instructions and directives to the district offices, but that all detailed work is done by the district staff. In some outstandingly important cases, where there is a conflict of views between the administration and the taxpayer, there will be discussions with the Director-General at Head Office.

Individual Assessing

This district office unit has numerous subdivisions to facilitate assessing according to the character of the work required. Returns of individuals in business, professional people, and farmers—the last are important in some districts—are dealt with by trained assessors; people with investment incomes and the returns of salary and wage earners, by assessing clerks on a mass production basis, which involves a close liaison with filing, tax roll, and other branches of the district office administrative unit to ensure an even and free flow of work. Since the introduction of tax deduction at the source, approximately one-half of the returns made by salary and wage earners have involved refunds.

Returns of taxpayers in business and the professions and farmers with incomes of over $5,000, and other taxpayers with incomes over $15,000, are reported to the Head Office and dealt with in the same manner as corporations, by the staff of the Director-General, Individual Assessing.

With all other individual returns, assessments for balances due or refunds payable are sent out to taxpayers on the basis of the assessment made by the district office. These in number are some 80 to 90 per cent of the whole number of individual returns filed.

Administrative Unit

Under the senior officer of the district office are the supervisors of numerous subdivisions, cashiers, tax rolls of individual taxpayers and attached delinquent section, accounting with a

ledger card for every taxpayer, a filing unit, with a separate folder for every taxpayer, a collection unit dealing with those in arrears up to the point where legal action may be necessary, the deduction at source unit with its records and payroll auditors, and the appropriate typing and clerical staffs.

Work of this unit, as already indicated, particularly filing, accounting, and collections must be tied in very closely with the work of the individual assessing unit.

Administrative methods are laid down by the Director of Administration at the Head Office. Proposed changes, after first development at the Head Office, are usually discussed by a committee including representatives of district offices, and new methods are tried experimentally in one or other offices.

In addition to these three main divisions, corporation assessing, individual assessing, and the administrative unit, there are in the district office, some smaller branches, including succession duty, which is declining in volume of work as a result of 1948 legislation raising the limit of dutiable incomes to $50,000; and an intelligence or special investigation unit in which trained men deal with cases of fraud.

Head Office

This is in broad outline a picture of the activities of the typical Canadian income tax district office. You will have gathered that the functions of the Head Office in relation to the district office are that of final decision of intricate and involved questions through review of the more important taxpayers' files, of control and direction of the flow of work, whether assessing or administrative, and of the methods to be followed in handling it. In short the Head Office controls policy. Additionally, the Head Office maintains knowledge of and control over the district office through an inspection staff, and each district office has its permanent staff of internal auditors, who report to the chief inspector at the Head Office.

Legal interpretations and appeal work are concentrated in

the legal branch at the Head Office, though district offices are required to do fact-finding work in connection with appeals.

ADVANTAGES AND DISADVANTAGES OF DECENTRALIZATION

With these decentralized methods of administration, the framework of which has been outlined, there have of course been found some disadvantages as well as advantages. One of the advantages on which we lay stress in Canada is the fact that under our system, a taxpayer can go to his local office, instead of writing to Ottawa, to discuss his taxation problem or returns, or if necessary, tell his story of grievance to an officer who is competent to deal with the matter. This is in addition to the advantage of making returns and payments, of whatever kind covered by the Income War Tax Act, or other acts administered by the Income Tax Division, all to the one office, and having his books and records examined by an officer from the same office. The principal disadvantages which we have found are two: the difficulty of securing uniformity in widely scattered offices, and the difficulty both of securing and retaining senior technically trained staff in the district offices located in the smaller centers.

These two matters are closely related, because by the term uniformity is intended not only uniformity in the assessment of taxpayers whose circumstances are similar, wherever they may make their returns in Canada, but also uniformity in the progress of the Division's work. It is for instance, to take an extreme case, obviously undesirable that in one district area, corporation assessing should be on a virtually current basis, while in an adjoining district area this work should be several years in arrears.

These and related problems have been vigorously taken in hand within the last year or two. Staffs, both technical and clerical, have been largely increased and additional space, unobtainable during the years of war, secured. Processes have been changed, as material and supplies for the use of new processes have been made available. Further changes of this kind are

under active consideration and will be going on for some time.

New Income Tax Act

An important development in the matter of securing greater uniformity in our Canadian income tax administration is the new act, which was passed by Parliament at its last session, and comes into force on the 1st January, 1949. As many of you will be aware, our Income War Tax Act has only been once consolidated, in 1927, and the effect of annual amendments upon it, particularly the tremendous changes of the Second War years which revolutionized income tax in Canada, has been to make it unwieldy and ill-arranged.

As many of you will also know, one of the features of our existing act is the large number of "Minister's discretions," in effect administrative discretions, which it contains. In the new act, these have been done away with, only two or three remaining, and we are turning towards the rule of law.

A first draft of the new bill was introduced into Parliament at the close of the 1947 Session, but instead of being proceeded with immediately, was made available for study and representations by interested parties. Such bodies as bar associations, chartered accountants' institutes, the Canadian Tax Foundation, boards of trade, and chambers of commerce devoted a great deal of attention to it. The bill was then redrafted, after consideration of representations by these bodies, and the redrafted bill was passed by Parliament into the Income Tax Act at the 1948 Session, and as stated, comes into operation on the 1st January, 1949.

Apart from the sweeping reduction in the number of ministerial discretions, features of the bill are an orderly arrangement of sections covering procedure, which in the present Act are widely scattered, and a considerable simplification of language. The Act, however, is much more than a consolidation or simplification. It contains a good deal of new matter, which

should be studied by those who are practically or professionally concerned with Canadian taxation.

It will be necessary to issue regulations under the new Act, covering such important matters as inventories, depreciation, depletion, and a number of other matters. These regulations are now in process of preparation, will come into force through Orders-in-Council and be published for the information of taxpayers.

The new Act and its regulations will assist notably in overcoming any lack of uniformity developed as a result of our decentralized methods of administration. One other administrative objective which we are actively working towards at this time is simplification not only of our office methods—by mechanical means or otherwise—but in particular of forms which the great body of taxpayers has to complete for us. Last year for taxpayers with incomes of $3,000 or less—and this classification includes in number approximately four-fifths of the returns we receive—we tried a simplified form a little larger than post-card size. It had its points, but we had considerable difficulty with it administratively. Accordingly, we are trying again, a slightly larger but still small four-page leaflet. Both in this form and in a revision of the income tax form for individual taxpayers with incomes over $3,000, we are getting away as far as possible from legalistic verbiage while covering all requisite information.

Any administrative novelties along these and other lines are naturally subject to the requirements of government policy. But with this proviso it may be fairly said that our aims in Canadian income tax administration at this time are the assurance of uniformity, and simplification, leading ultimately to further decentralization, particularly for the mass of returns, whether of taxpayers' or information returns.

APPENDIX

The Taxation Division of the Department of National Revenue of the Canadian Government administers three acts of Parliament:

The Income War Tax Act, enacted 1917
The Excess Profits Tax Act, 1940
The Dominion Succession Duty Act, enacted 1941

The Income War Tax Act will be succeeded by the Income Tax Act, enacted 1948, on the 1st January 1949.

By agreement between the Dominion and seven provinces, the Taxation Division administers the corporation taxation of these provinces. It also by agreement administers the corporation tax of the Yukon Territory.

In the past, the Division has administered the Business Profits War Tax Act (1915-1920), and the Wartime Salaries Control (1941-1946).

Offices are located as follows:

HEAD OFFICE

444 Sussex Street, Ottawa, Ontario

DISTRICT OFFICES

Prince Edward Island:	Charlottetown
Nova Scotia:	Halifax
	Sydney
New Brunswick:	Saint John
Quebec:	Quebec
	Montreal
	Sherbrooke
Ontario:	Ottawa (Jackson Building)
	Kingston
	Belleville
	Toronto
	Hamilton
	London
	Fort William
Manitoba:	Winnipeg
Saskatchewan:	Regina
	Saskatoon
Alberta:	Edmonton
	Calgary
British Columbia:	Vancouver
Yukon Territory:	Dawson

Collections of All Taxes Administered: Net After Refunds

(Fiscal Years Ended 31st March)

1919	$ 42,319,782
1920-29, annual average	66,603,080
1930-39, annual average	83,927,458
1940	134,448,566
1941	272,138,291
1942	652,367,936
1943	1,378,042,832
1944	1,635,494,706
1945	1,555,814,222
1946	1,453,373,330
1947	1,435,731,759
1948	1,317,706,891

Percentage cost of collections, (excluding building rentals and the rental value of space occupied in government buildings):

1948: 1.49%.

For details of collections etc., see *Taxation Statistics, 1948,* published by the King's Printer, Ottawa.

Returns Received

Population of Canada, 1948	12,883,000
Income tax returns of individuals filed for 1947 to 30th Sept. 1948	3,554,675
Corporation income tax returns filed for 1947	40,546
Information returns filed during fiscal year 1947-1948 (returns of salaries and wages paid, dividends distributed, trust funds and estates, bond interest paid, and coupons cashed).	3,059,993

Staff

	Head Office	District Offices
1st September, 1939	209	1,140
1st October, 1948	891	10,703

PART FOUR

FEDERAL INCOME TAX ADMINISTRATION: SPECIFIC ADMINISTRATIVE PROBLEMS

CHAPTER XI

DEPRECIATION ALLOWANCES

PAUL T. NORTON, JR.
Vice President & Treasurer, The Case Crane & Kilbourne Jacobs Company

THE WHOLE PROBLEM of depreciation is really one of administration. The law merely provides that there shall be a reasonable allowance for depreciation. Present administrative practice has become so deep-rooted through long usage and court decisions, however, that some changes in the law itself would almost certainly be required before some of the changes I shall suggest could be made.

I shall not attempt to discuss fundamental depreciation theory, but will try to show how we can do a better job than we are now doing in handling depreciation allowances on income tax returns. My entire discussion will be based on the assumption that the one and only reason our tax law permits a deduction for depreciation is to prevent the charging of an income tax on that part of the gross receipts of a business which is merely the return of an investment in a depreciable asset.

HIGH REPLACEMENT COSTS

I do not believe that there is any direct connection between depreciation and replacement, or between depreciation and the replacement *cost* of an asset. Most of the jobs I have held in my forty years of working experience have brought me into close contact with the manufacture, sale, or use of manufacturing equipment, and no one knows better than I that an industrial concern must be able to replace its assets, if it is to survive. In fact, I would go much further, and say that merely replac-

ing assets is not enough. If we are to continue our long-time progress in increasing the national standard of living, we must find some way to continue our past habit of increasing the mechanization of industry, and not merely replace assets as they wear out or become obsolete. But the financing of replacements is a problem quite separate from the writing off for tax purposes of the investment in present assets.

The replacement problem is aggravated today by the combination of two elements, high tax rates and high replacement costs. As I shall point out later in this talk, our present depreciation tax practice seriously interferes with desirable, even essential, replacements. I am in complete agreement with what I understand to be the *objectives* of those businessmen, accountants, and engineers who are advocating that taxpayers be permitted to charge depreciation on the basis of replacement costs, but I personally am convinced that this is a completely wrong and futile approach to the problem. I shall merely say at this time that I believe that the only feasible way to handle the problem resulting from the present high replacement costs is to recognize the fact that the present combination of high replacement costs, high tax rates, low depreciation rates, and the threat of being penalized under Section 102 will almost certainly destroy our present private ownership economy, unless some relief is given promptly through changes in our method of taxing what we now consider to be the "profits" of business.

If I had enough time, I believe I could demonstrate to the satisfaction of nearly everyone that permission to charge depreciation for tax purposes on the basis of present high replacement costs would ultimately be bad for industry, even if such permission could be obtained, which I hope and believe will never happen. To tie these extra charges in with depreciation, as so many of our large companies are now doing, although such extra charges are not permitted for tax purposes, seems to me to be very unwise.

I believe that by attacking the problem directly industry

could do a much better job than it is now doing in proving to the public that the present large "profits" of industry are necessary, and must be used by industry for working capital and for investment in new plant and equipment, if industry is to survive, to say nothing of maintaining an up-to-date national productive plant. That approach might even get some tax relief for that part of the presently taxed "profits" which are reinvested in depreciable assets. But the method of attacking the problem which I have just suggested should not be tied in with the quite separate problem of depreciation charges on present assets.

Why should we attempt to make the depreciation instrument do a job it was never intended to do and which all the available evidence indicates it will not be able to do satisfactorily? As I wrote this paper, I had in front of me some score of different published statements giving as many different reasons why the authors do not believe it to be desirable to make additional depreciation charges on present assets to cover present inflated replacement costs. The very fact that so many different groups have attacked this method from so many different angles is enough to satisfy me that the general public, already suspicious of the supposed high "profits" now being earned by industry, will never believe that there is a real economic justification for the practice.

I have still another reason for objecting to this practice as it is now generally being used: I believe it makes it more difficult to improve our present depreciation practice in the field in which depreciation can and should operate.

So much for the problem of high replacement costs. The remainder of this paper will be devoted to those aspects of the depreciation problem which refer to the tax-free recovery of the dollar investment in a depreciable asset.

Prosperity Requires a High Level of Plant Investment

That our postwar prosperity depended to a great extent upon a large amount of postwar investment in plant and equipment

was recognized as far back as 1944 by the very federal officials under whom the government had so drastically reduced depreciation allowances during the previous ten years. We all remember that President Roosevelt and several of the highest members of his administration stated in 1944 that depreciation allowances on postwar investments should be increased as an inducement to business and industry to make investments in plant and equipment, and thus maintain a high employment level.

The postwar depression which was so greatly feared has not as yet materialized, and we have certainly not needed any relaxation of the Treasury's depreciation practice to induce businessmen to make very large investments in depreciable assets. I do not believe, however, that we can expect the present situation to continue indefinitely. Nor do I believe that businessmen will make investments in plant and equipment *merely* because the government gives them a tax inducement through a more liberal depreciation policy.

If we accept the premise that businessmen will not ordinarily make investments in plant and equipment unless they expect to recover their investments plus a return on the investments, it seems to me that we should be fearful lest a continuation of our present depreciation practice may suddenly cause many businessmen to decide that they simply cannot afford to make additional investments in depreciable assets.

If we analyze the reasons why investments in plant and equipment are still being made in such large volume, it seems to me to be clear that these reasons may be divided into three classes.

The most important reason why investments in plant and equipment are being made today by big business and small business is probably the quite justifiable belief on the part of most businessmen that their present facilities are simply not modern enough or efficient enough to make it possible for them to compete while paying present high wage rates. The urgency of this first reason will presumably diminish as time goes on.

The second reason applies principally to big business and

is more political than economic. It seems clear that such industries as steel and petroleum products have no choice at present, but must continue to increase their productive capacities, even though they may question the economic advisability of some of this expansion. If they do not make the investments themselves, the government will certainly do so. Sooner or later, we should certainly reach the point where even such large industries can decide for themselves whether to continue to expand.

Finally, discussion of the problem with many businessmen, representing both big business and small business, has convinced me that the average businessman does not yet grasp the full implications of our present depreciation practice, nor that under this practice it is often not possible to recover an investment *tax-free* even when the asset in which the money is invested is very profitable from an economic viewpoint. There are indications that the average businessman is becoming better educated with respect to this point, and as this education becomes more general there will certainly be more and more reluctance to make those investments which are being made so freely today, and which are clearly justifiable from the economic and social viewpoints, although not from the viewpoint of what will happen under our present tax practice with respect to depreciation.

When so analyzed, it seems clear that much of our present great investment is being made for reasons which are not at all normal, and if conditions should change with respect to one or more of these three reasons, there might be a great decrease in the rate at which investments would be made in plant and equipment. If the change were rapid enough, the result might be disastrous. In that connection, it is perhaps only fair to say that present depreciation practice is not as harmful to big business as it is to small business; investments in plant and equipment by big business might not cease as quickly as would presumably be the case with small business, after the small businessman once begins to realize what is really happening

to him under present depreciation practice. On the other hand, important as big business is in respect to investment in plant and equipment, in the aggregate small business must be even more important. In any event, a decrease in such investments by any large segment of business might become contagious.

Prevalent Errors Regarding Depreciation

There can be no real hope of any considerable improvement in our method of handling depreciation until some all too common errors are corrected in the minds of the general public, as well as many businessmen, engineers, and accountants. It is especially important that the general public have a better understanding of what happens when depreciation charges are made under what is generally considered to be good accounting procedure; it is certainly most important that the general public understand that depreciation reserves do not represent money in the bank available for the purchase of replacement assets.

An examination of these misunderstandings of the nature of depreciation allowances may assist us in making up our minds as to how the present practice of the Treasury can best be changed so as to come closer to the real reason for permitting depreciation allowances on income tax returns. Let me say first, and most emphatically, that in singling out certain periodicals for direct quotation, I am merely using them as typical examples of the usual thinking in respect to what I consider to be very general errors.

Depreciation Reserves Are Not Money in Bank

One of the frequent errors is that depreciation reserves represent money in the bank. The September 30, 1948, issue of *The Wall Street Journal* contained an article entitled "Phantom Profits," which, after having stated that a certain company was continuing to use an old plant and another company was omitting its common dividend, both of them because of present high replacement costs, included the following paragraphs:

> These two tales typify a major problem for businessmen today. Depreciation reserves aren't big enough to replace rundown plants and machinery at present high costs.
>
> Depreciation is a bookkeeping charge which a company makes against its earnings to offset the wear and tear on its plants and machines in making bobby pins, automobiles, refrigerators, machine tools, or whatever it sells to customers. Theoretically, the reserve accumulated over the life of a plant or machine should be sufficient to buy a new one when the old one wears out.
>
> For a machine costing, say, $10,000 with an estimated 10-year life, $1,000 would be set aside each year. At the end of 10 years, $10,000 would thus be in reserve to replace the worn out tool.

It is certainly not necessary for me to explain to this audience why nothing can be purchased through the use of depreciation reserves. With statements like this appearing in periodicals like *The Wall Street Journal,* however, can we wonder that the general public is misled by those persons who point to what they claim are excessive depreciation reserves, and infer, if they do not definitely state, that these reserves might well be used to replace plant and equipment? (Of course, the word "surplus" is used in ways that are even worse, but a discussion of that is not within the subject of this paper.) I am sure that no one who has attended union negotiating sessions will feel that I am quibbling when I state that we simply must be more careful of our phraseology in matters of this sort.

The statement quoted was directed particularly at present high replacement costs, but it would have been exactly as incorrect, or at least as misleading, in a period of stable prices.

No Ascertainable Amount of Depreciation for any Given Year

A second frequent error is that there is any definite ascertainable amount of depreciation for any given year, and particularly that it is the amount that is calculated by using straight-line depreciation rates based on full service life; also the resulting error in thinking that the Treasury's present practice recognizes obsolescence in an effective way. As an example, I shall quote a paragraph from the editorial on depreciation in the December, 1944, issue of *The Journal of Accountancy:*

No certified public accountant could properly certify without qualification a statement of income based on depreciation charges higher than that part of total cost reasonably attributable to the year in question.

The quotation I have just read seems to express the rather general objections of accountants to what might be called "accelerated depreciation," or, in other words, the charging of higher depreciation rates in the early years of the life of an asset than would be the case with straight-line depreciation, with rates based on full service lives.

It certainly would be wonderful if depreciation, and all other elements of cost, could be determined accurately each year. It would take too long for me to explain fully that the rate at which the investment in an asset should be written off during life is, in general, completely indeterminate. I shall merely say, at this time, that it is not at all unusual for an asset with a total service life of, say, twenty years, to have little or no capacity for earning its depreciation in the last five or ten years of life, because obsolescence has relegated it to stand-by service. It is this sort of thing which makes me so sure that depreciation rates in the early years should, at least for most manufacturing equipment, be higher than straight-line rates based on full service lives.

By the way, those accountants and others who object to so-called accelerated depreciation for the reasons implied in the quotation from *The Journal of Accountancy,* are really in agreement with the present practice of the Treasury. I only wish I had time to explore that subject further.

The Treasury regulations purport to give recognition to both "normal obsolescence" and "extraordinary or special obsolescence." However, a careful consideration of Treasury practice will prove that in no case does the Treasury recognize any effect of obsolescence other than the effect it has in ending life, and it must be remembered that, to the Treasury, life has not ended as long as the asset is in use, even when such use is the most limited sort of stand-by service. Few persons seem to realize that the Treasury's present practice completely ignores

the more important effect of obsolescence, in reducing earning power—the ability to earn depreciation—*during* life. Certainly few critics of the Treasury's present practice have attacked the Treasury practice from that point of view. I cannot understand this failure to attack present practice at the point where I consider it to be most vulnerable, and the prospects of success the brightest.

Tax-free Recovery of Investment

A third error is that it is always possible for a taxpayer to recover *tax-free* the investment in a depreciable asset, which has in fact been profitable enough for him to recover the investment during the economic life. There seems to be no doubt as to the intention in the law and regulations that such tax-free recovery should be permitted.

As to this, I shall merely call attention to the two opposite situations where assets earn their investments fully during their lives, but where in the first case, the asset is profitable only during the first part of its life, being obsolete thereafter, while in the second case, there is no real earning power in the early years, but the entire investment is recovered in the later years. (There are, of course, many variations of these two situations.) Few persons seem to realize how Treasury practice can penalize a taxpayer in situations of this sort, especially small companies who are less able than large companies to average losses due to one asset against earnings from other assets.

Permissive Acceleration of Depreciation Charges Cannot Involve Future Hardship

Another error is that permission to accelerate depreciation charges, under the present limitation that such charges must not exceed total cost, might work a hardship on the taxpayer in later years, after the depreciation base had been exhausted. This idea is illustrated by the following paragraph on accel-

erated depreciation from page 45 of the November 12, 1948, issue of the *U. S. News & World Report:*

> Objection is made to this plan, however, on the ground that it might be disastrous to some firms in time. Today, for example, a company might decide to take its extra tax reduction when taxes are high and profits easy. But if the firm depreciated its equipment in a few years, it would get no deductions later on, would have to pay heavier taxes. If business conditions were poor then, the tax load might be very heavy.

This statement is so badly in error that it seems incredible that it could have been written, but I have seen several other statements that were almost identical. Limitations of time permit me only one comment. What could be better than to be relieved of the necessity of charging depreciation into one's costs; that is one step better than buying good plant and equipment at a very low cost at a sheriff's sale, which gives rise to the most feared of all competition.

No Historical Justification for Straight-Line Depreciation

A final error is that there is historical justification for the use of straight-line depreciation. It is true that in the period prior to the issuance of Treasury Decision 4422 in 1934, most taxpayers did use for tax purposes what was generally called "straight-line depreciation." However, it was common practice in the manufacturing industries to use a 10 per cent straight-line depreciation rate for manufacturing equipment, even though it must have been apparent to everyone that the lives of such equipment averaged considerably more than ten years. It seems strange that so few persons realized that the change in Treasury practice which occurred in 1934 was a complete change in method, and not merely a refinement of the method that had previously been used, and which was, in my opinion, a much better method than the one insisted upon by the Treasury since T.D. 4422. Far too often, taxpayers attack the present maximum depreciation rates permitted on tax returns on the ground that the lives used by the Treasury are unreasonably long. This method of attack is, in most cases, doomed

to failure; the Treasury has ample information to justify its lives. To obtain higher rates, taxpayers must show that the whole theory of basing straight-line rates on full service lives is wrong because such a method does not permit the tax-free recovery of an investment during the period within which it must be recovered, if it is to be recovered at all.

Some Suggestions for Improving Depreciation Practice

I have not yet made definite suggestions for improving depreciation practice in federal income tax administration. However, what I have said will, I hope, assist us in understanding the reasons for the few suggestions I shall now make.

First, and most important of all, let us see what we can do to improve depreciation practice without asking that it do for us things it was never intended to do. In particular, if we feel that high replacement costs require recognition when reporting profits, as I am convinced they do, let us not give the name "depreciation" to the additional current charges which we may find it desirable to make, unless we can justify these charges as reasonable on a dollar cost basis, through the use of what is generally called "accelerated depreciation." If we handle the problem in this way, I believe we have a fair chance to educate the general public to the point that they will accept present business profits as being reasonable in view of the need for additional sums for working capital requirements and plant replacements and additions.

Let us see what can be done within the framework of regular depreciation accounting to alleviate the problem of high replacement costs. For example, some rough mental arithmetic which I have used on the figures given in *The U. S. Steel Quarterly* for November, 1948, indicates that the additional depreciation charge being made this year, and not now deductible on the tax return, amounts to only about 10 per cent on a yearly basis on the investments in plant and equipment which the company has made during the postwar period alone. I believe that the economic justification of such "accelerated

depreciation" could be explained to the general public, and that we might even expect to get such allowances on income tax returns.

But I am convinced that "accelerated depreciation" can be justified only if it can be shown that it is economically sound, as well as socially desirable in that it will promote desirable investments in plant and equipment. Like most other businessmen, I distrust, even fear, "incentive taxation," and I do not believe that accelerated depreciation will ever be generally accepted, or have the effect desired by its proponents, until it can be shown to be economically sound. (I do not have the time to give the reasons why I am convinced that it really is economically sound, because that is the way that depreciation normally occurs.)

Present depreciation practice, with maximum straight-line rates based on full service lives, has two very bad effects, which will become more evident as taxpayers more generally grasp the full implications of present practice.

In the first place, with high tax rates, low depreciation rates, and the threat of being penalized under Section 102, taxpayers may often be financially unable to make replacements when it becomes evident that their existing assets are obsolete. There is ample historical evidence that the failure to give adequate recognition to depreciation has resulted in disaster, not only to individual concerns but also to entire communities.

The second bad effect of present practice will become evident just as soon as the average taxpayer realizes that the easiest way for him to increase his depreciation rates is to retire ruthlessly any asset for which there is no need in the immediately foreseeable future. There are those who believe that such retirements of assets are desirable in that they keep our national plant free of obsolescence, but I am sure that the retirement of assets merely to gain a tax advantage is bad from the viewpoint of our national economic health and safety. Certainly much of the obsolescent plant which was still in existence in 1940 was of great assistance in the war effort; it was

fortunate that this plant had not been retired merely to provide a tax advantage to its owners. Surely there can be no objection to the retention of stand-by plant which might be useful in the future, and which it costs nothing to retain; nothing, that is, except a severe tax penalty under present depreciation practice.

Conclusion

It may be felt that I have crowded too many topics into this short paper. I can only say that I am convinced that a proper administration of depreciation allowances for federal income tax purposes demands that all of these topics be considered. The problem is so complicated and so indeterminate that it probably never will be solved to the satisfaction of everyone. I believe, however, that we can greatly improve present practice by recognizing that it is economically sound to permit what is generally called "accelerated depreciation," and that there is no real justification for our present practice, which in effect assumes that an old and obsolescent asset has the same earning power in its last year of life as it had in its first year of life.

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Note: An explanation of the reasons for the statements made in this paper may be found in *Depreciation,* by Grant, E. L., and Norton, P. T., Jr., New York: Ronald Press Company, 1949.

CHAPTER XII

COMPENSATION PROBLEMS

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SPEAKERS on the subject of taxation sometimes, by way of illustration, refer to Adam and Eve in the Garden of Eden. My assigned subject being "Compensation Problems," I wonder if it could be held that Adam realized taxable income in the form of compensation when he took the bite out of the well-known apple. He might contend that he rendered no services and that the apple was intended as a gift; or he might pass the buck to Eve on the theory that any income is hers since she gave him only the fruit and not the whole tree. The fruit was forbidden, however, under the statutes existing at that time, and the apple was not Eve's to give away. When we next consider whether Adam, therefore, realized income by way of theft or embezzlement we are getting away from compensation concepts. In any event there apparently was no forgiveness of any indebtedness.

Today, compensation received for services rendered is one of the more common forms of taxable income and compensation paid is one of the largest deductions taken on tax returns of employers. While, generally, tax treatment of receipt or payment of compensation is comparatively simple, it is somewhat more complex than it was in the Garden of Eden and there are some problems which are important enough to cause concern to both employee and employer.

* The views expressed herein are entirely those of the writer, and should not necessarily be construed as the official opinion of the Bureau of Internal Revenue.

Compensation stalks into the income tax field when a person has received it or is entitled to receive it. When such person is so circumstanced that means that another person has paid compensation or is obligated to pay it. Both are then presented with four basic questions. The payee's questions are:

1. Is it taxable?
2. When is it taxable?
3. How much of it is taxable?
4. Is it taxable to me?

And the payer's questions are:

1. Is it deductible?
2. When is it deductible?
3. How much of it is deductible?
4. Is it deductible by me?

These simple questions have given rise to untold thousands of disputes, rulings, and court decisions. During recent years high tax rates have placed a good premium on the vigorous exercise of human ingenuity to devise means of minimizing tax liability. They have also stimulated the enactment of some tax provisions with a social purpose implemented by the offer of certain tax benefits in the field of compensation.

The natural concomitants of pressures such as those indicated are, of course, problems. I shall have time to mention only a few and to touch only lightly on these.

Receipt of Compensation

To pause for a moment and consider fundamentals—we are all aware that income derived from salaries, wages, commissions, bonuses, tips, or compensation for personal services of whatever kind and in whatever form paid falls into that revenue kettle bearing the cold impersonal title of "gross income." And it is widely known that such income may be in the form of cash, corporate stock, merchandise, living quarters, meals, and goods or services of any kind. We all know that if services are paid for with something other than money, the fair market

value of whatever is received in payment is the amount to be included as income. In fact, an amount received from refraining from labor is sometimes considered to be compensation and taxable as such.[1]

The full scope of these fundamental ideas is not apparent to the naked eye. There are numerous, let us call them, subtle nuances which breed the problems. Some examples are indicated in the following paragraphs.

The value of board and lodging furnished an employee constitutes taxable income to him *unless* noncompensatory because they are furnished for the convenience of the employer.

The rental value of a dwelling and household furnishings provided a clergyman by his church is not taxable to the clergyman. However, if the clergyman rents a house that is not owned by the church, and is provided an allowance to pay the rent, the allowance is income to him subject to tax.

Salary received from an employer by an employee while absent from work on account of sickness is considered taxable to the employee, but amounts received by him through health insurance as compensation for sickness is specifically excluded from gross income under Code Section 22(b) (5).

Premiums paid by an employer on policies of group life insurance covering the lives of his employees, the beneficiaries of which are designated by the employees, are by regulation not income to the employees. If, however, a pension or profit-sharing trust established by an employer for his employees purchases retirement income insurance with life insurance protection payable upon the death of the employee participants, so much of the premiums as was paid from the contributions of the employer or earnings thereon for such life insurance protection constitutes income to the employee for the year in which such amounts are applied to the purchase of the life insurance.

1 *Helvering* v. *Salvage*, 297 U.S. 106.

Gifts Distinguished from Compensation

While there is a strong presumption that any payment made by an employer to his employee or former employee represents taxable compensation for services rendered, the courts have held that sometimes such payment is intended as a gift and as such is exempt from tax.[2] The answer usually hinges on the intent of the parties and the surrounding facts.

Section 107

Under certain conditions prescribed in Section 107 of the Code a taxpayer who receives in one year substantially all of the compensation earned from services covering a period of thirty-six months or more may determine his tax liability under a special rule provided in that section. Special provision is also made for computing the tax of an individual receiving "back pay" amounting to more than 15 per cent of his gross income for the taxable year.

Stock Options

A lively term to mention in any discussion of compensation "problems" is "stock options." By "stock option," of course, I have reference to the situation where an employer corporation gives an employee an option to purchase the corporation's stock at a particular price, the option usually to be good for a period of years and exercisable under circumstances in which the price paid for the stock on exercise of the option is usually favorable to the employee.

Under existing rules, if property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or an exchange, the difference between the amount paid for the property and its fair market value is taxable income to the employee. This rule is applied to options to buy stock of an employer corporation. It is held that the employee realizes

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[2] *Bogardus* v. *Commissioner,* 302 U.S. 34 (1937).

compensation in the year the option is exercised to the extent of the excess of the market value of the stock over the option price. If the option is sold, the value of the consideration received is taxed as compensation. If the option is given away, the employee is subject to tax when the recipient exercises the option.

A number of proposals have been made to create a special statutory rule applicable to stock options. The proposals are usually erected on the premise that such stock options are incentive devices to stimulate the employee's zeal to build up the corporate business because of the opportunity of part ownership and participation. A further premise is that such an incentive device is not compensatory but is more in the nature of a capital transaction and that the financial benefits the employee receives should be regarded as capital benefits.

One such proposal has been incorporated in H.R. 6712 in the Eightieth Congress, a bill which passed the House of Representatives. I have been informed that this provision has been criticized from several sources as too restrictive in its terms. I have also heard that several groups have endeavored to draft an alternative measure, having the same objectives as that in H.R. 6712, but with different rules. But, I gather that these groups have not been able to agree among themselves on their own proposals.

Deductions by Payer of Compensation

My comments thus far have been in connection with the receipt of compensation. Let us look at it a bit from the payer's standpoint. It does not necessarily follow that amounts paid by an employer to an employee or to an independent contractor are deductible by him merely because they are taxable as compensation to the recipient. The payments, in order to be deductible, must be reasonable and constitute ordinary and necessary business expenses. For instance, salary payments to corporation employees who are stockholders may represent dividends rather than deductible compensation. Or, if the

shareholder employee reports his income on the cash basis and owns more than 50 per cent in value of the outstanding stock, Section 24(c) of the Code provides that no deduction is allowed the employer if compensation due the shareholder is not paid within the taxable year or within two and one-half months after the close thereof.

It is also well to note here that some corporation payments which are actually taxable compensation to the recipient may be a capital expenditure as far as the company is concerned—for example, legal fees for incorporating the company.

Amounts paid as compensation are not always deductible in the year paid but may be deductible in some other taxable period. For example, amounts contributed by an employer to a pension trust, or an annuity plan for past service credits, are allowable as deductions under clause (iii) of Section 23(p) (1) (A) only to the extent of 10 per cent of the amount required to completely fund such past service. Deduction for payment in excess of this amount is carried over and is deductible only in succeeding taxable years to the extent of the 10 per cent limitation.

Reasonableness of Compensation

The test for reasonableness of compensation paid sometimes takes into consideration both current and past services rendered by the employee.[3] This test also applies to amounts contributed to employees' trusts. Section 29.23(p)-1 of Regulations 111, as amended by T.D. 5666, provides that:

> In no case is a deduction allowable under section 23(p) for the amount of any contribution for the benefit of an employee in excess of the amount which, together with other deductions allowed for compensation for such employee's services, constitutes a reasonable allowance for compensation for the services actually rendered.

The Regulations go on to say, however, that a contribution which is in the nature of additional compensation for services

[3] *Lucas* v. *Ox Fibre Brush Co.,* 281 U.S. 115.

performed in prior years may be deductible, even if the total of such contributions and other compensation for the current year would be in excess of reasonable compensation for services performed in the current year, provided that such total plus all compensation and contributions paid to or for such employee in prior years represents a reasonable allowance for all services rendered by the employee by the end of the current year.

Pension, Annuity, and Profit-Sharing Plans and Deferred Compensation

Much time could be spent in discussing the various compensation problems arising under stock options, the constructive receipt doctrine, reasonableness of compensation, or under Sections 24(c) and 107. I shall, however, confine the balance of this discussion to some of the current problems in connection with compensation involving arrangements under which such compensation is deferred. Under these arrangements the employee does not receive actual payment of compensation until some later period. One method of deferring the receipt of compensation is the establishment by an employer of a pension, annuity, profit-sharing, or stock-bonus plan for his employees under which compensation is set aside in trust for pensions, or as a share of the employer's profits, or through the purchase of annuities from an insurance company.

Prior to 1940 there were approximately one thousand of these trusteed or insured plans in existence. At the present time, however, more than twelve thousand such plans are in effect covering around four million employees and involving annual contributions by employers of somewhere between seven hundred and fifty million and one billion dollars.

In general, the Internal Revenue Code provides that where such a plan meets the requirements of Section 165(a), the contributions made to the trust or the premiums paid for the annuities by the employer are not taxable to the employee or his beneficiary until the contributions are actually distributed

or made available to them. However, the contributions made by the employer are deductible within certain limits in the year made.

Under existing law distributions made under qualified plans are taxable to the distributee as annuities to the extent provided in Section 22(b)(2), except that if the total distributions payable from a trusteed plan are paid to the distributee in one year and in a lump sum on account of the employee's separation from service, the amount taxable is taxed as a long-term capital gain. It is noted that lump sum payments from nontrusteed plans are not accorded the capital gain treatment.

Where the plan fails to meet the requirements of Section 165(a) the contributions made by the employer are included in the employee's gross income for the taxable year in which such contribution is made to the extent that the employee's beneficial interest in such contribution is nonforfeitable at that time. If the employee's interest is forfeitable at the time of the payment by the employer, the employee need not report the amounts due him until eventually received or made available to him, but in that case the employer is never allowed a deduction for his contributions.

While we are on the subject of pension and profit-sharing trusts I would like to discuss one or two of the current problems there involved.

There has been some indication that the tax and benefit base under the old-age and survivors' insurance program of Social Security might be increased from $3,000 to $4,200 or $4,800. If this should occur a question is raised as to its effect on private pension and annuity plans which are integrated with present Social Security benefits.

The Code [4] permits plans to qualify which supplement the Social Security program; but the Commissioner in making his determination with respect to discrimination considers whether total benefits resulting to each employee under the plan and under the Federal Insurance Contributions Act establish an

4 Section 165(a) (5).

integrated and correlated retirement system. In this connection the Bureau of Internal Revenue has issued Mimeograph 5539 which provides for the application of certain formulae to plans covering only employees earning over $3,000 per year which will be accepted as integrated with Social Security benefits. In the event of any increase in this base, plans now integrated might be found to overlap so much with the new old-age and survivors' benefits that they could no longer be considered as properly integrated and nondiscriminatory.

Whether legislation in this field may require modification of existing employees' plans will probably depend on the extent of the increase in basic benefits. If the differential is not substantial, continued approval of plans which have qualified under present integration requirements, and also new plans conforming to these requirements, might be justified under the existing provisions of Section 165(a).

Another interesting question pertains to deductions allowable to employers for contributions to qualified pension trusts and annuity plans under clause (ii) of Section 23(p)(1)(A) where the pension or annuities are funded on a level annual basis and where such contributions made during the taxable year exceed the limitation prescribed in clause (iii) of that subparagraph.

Clause (ii) refers to an amount actuarially necessary to pay the remaining unfunded cost of all past and future service credits under the plan, distributed as a level amount or a level percentage of compensation over the remaining service of each employee, while clause (iii) refers to the actuarial cost of current service credits for the year plus an amount not in excess of 10 per cent of the amount required to immediately fund past service credits. The statute leaves the determination of specific actuarial methods to regulations to be prescribed by the Commissioner with the approval of the Secretary. The Regulations, in Section 29.23(p)-6, prior to their amendment by T.D. 5666, provided that if the employer desired to fund his plan under clause (ii), and such method funded the cost of

past service credits more rapidly than that permitted under clause (iii), he should submit the proposed method to the Commissioner and receive approval of such method before the results will be acceptable. The first case litigated under these provisions has recently been decided by the Tax Court on November 1, 1948, in the *Saalfield Publishing Company* case.[5] In this case the Commissioner had limited the taxpayer's deduction for its contribution to its pension trust to something less than the amount claimed as costs under a method of funding which the taxpayer contended conformed with clause (ii). The Court found that the excess deduction was apparently denied for the reason that the taxpayer's method of funding under clause (ii) happened to produce a deduction larger than that which could be obtained under clause (iii). The Court held that the Regulations, as so applied, are unreasonable and null and void.

It is noted that the Regulations,[6] as amended by T.D. 5666, approved on November 2, 1948, now illustrate a method of determining level costs as a basis of deductions under clause (ii) and permit other methods which are reasonable and appropriate under the circumstances involved, but still provide that if the amount is determined by a different method it must be approved by the Commissioner, except where it does not exceed the limitations under clause (iii).

Unfunded Deferred Compensation Plans

Only funded plans fall within the scope of Section 165. That is, such plans include some arrangement for placing funds in trust or for the purchase of annuities from insurance companies for employees in anticipation of future distribution to such employees.

Inasmuch as one of the requirements for qualification under Code Section 165 is that the plan must not discriminate in classification, contributions, or benefits in favor of officers or

[5] 11 T.C. No. 92.
[6] Section 29.23 (p)-6.

highly compensated employees, a corporation desiring to defer compensation to only one or a few of its key executives cannot use the vehicle of a trust fund or an annuity contract for this purpose without disadvantageous tax results. This may be one of the reasons for the recent popularity of so-called unfunded deferred compensation plans under which the employer—without the use of a trust or an insurance company—contracts with a selected key employee or employees, in exchange for stated considerations, to pay stipulated amounts to the employee over some future period, usually after retirement. Some forms of these deferred compensation contracts state that the rights of the employee to future payments become fixed and absolute upon the rendition of current services while others contain conditions or contingencies which must be met before the employee is entitled to any payments.

These conditional contracts may be occasioned by the corporation's desire to provide an inducement to certain management employees to remain in its employment or to attract top-notch men into the business; or the corporation may wish to insure itself against possible competition from such employees after severance of service from the corporation.

To accomplish this purpose the contract may provide that the payments are contingent upon the employee continuing in the service of the employer for a specified number of years or until a stated retirement age; they may be forfeitable if the employee, after severance of active service, enters into competition with the employer; or they may be subject to the condition that the employee continue to render advice or keep himself available for consultation after retirement.

Some students of the tax effects of such contracts maintain that an employee who enters into this type of contract and who reports his income on the cash basis is not in receipt of taxable income until he actually begins to receive the payments under the contract. Other students contend that the employee realizes taxable income in the taxable year in which the services giving rise to the rights to the deferred compensa-

tion are performed. They point out that the contingencies involving the deferred payments may often be of insufficient substance and not imposed for bona fide business reasons but are designed primarily, if not solely, to defer the imposition of the tax on what is actually currently earned compensation. They refer to the decision of the Supreme Court in *Commissioner* v. *Smith* [7] in which the Court held that Section 22(a) is broad enough to include in taxable income any economic benefit conferred upon the employee as compensation, whatever the form or mode by which it is effected. They point to the *Brodie,*[8] *Oberwinder,*[9] and related cases, where the employers purchased and delivered to selected employees as additional compensation a single premium annuity contract which had no cash or surrender value. No payments were to be made under the contracts until the taxpayers reached a stated age. The Courts held, in both cases, that the cost of each annuity was taxable to the employee in the year of purchase under the provisions of Section 22(a). They cite the *Miller* [10] case, involving the federal Civil Service Retirement System, wherein it was held that the amount withheld annually from the employee's salary for future annuities constitutes taxable income to the employee in the year earned even though not available to him until severance, retirement, or death. They find support in Section 41 of the Code which permits the Commissioner to compute income in accordance with any method that in his opinion clearly reflects the income.

Proponents of the "no tax until actual receipt" concept point to the *Veit,*[11] *Wolfe,*[12] *Robertson,*[13] and *Perkins* [14] cases, which they claim support their arguments in favor of taxability of deferred payments to a cash basis employee only as received.

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[7] 324 U.S. 177 (1945).
[8] 1 T.C. 275 (1942).
[9] 147 F. (2d) 255 (C.C.A. 8th, 1945).
[10] 144 F. (2d) 287 (C.C.A. 4th, 1944).
[11] 8 T.C. 809 (1947).
[12] 8 T.C. 689 (1947), *aff'd,* C.C.A.-9 (10-12-48).
[13] 6 T.C. 1060 (1945).
[14] 8 T.C. 1051 (1947).

Whatever the result, it should, in any event, be determined by reference to the terms and conditions of the agreement and the actual surrounding circumstances in each particular case. The Commissioner has not as yet published any indication of what position he will take with respect to the incidence of the tax to an employee entering into contracts of this type.

It does appear that the employer who enters into one of these contracts is not entitled to a deduction until he actually pays to the employee the amounts stipulated in the contract even though the employer is on the accrual basis of accounting. Section 23(p)(1)(D) of the Code reads in part that:

> . . . . if compensation is paid or accrued on account of any employee under a plan deferring the receipt of such compensation, such . . . . compensation shall not be deductible under subsection (a) but shall be deductible . . . . in the taxable year when paid . . . . if the employees' rights to . . . . such compensation are nonforfeitable at the time the . . . . compensation is paid.

The regulations in Section 29.23(p)-1 as amended by T.D. 5666 provide in part that:

> . . . . where a corporation is under an obligation, whether funded or unfunded, to pay . . . . deferred compensation to an employee, there is a method having the effect of a plan deferring the receipt of compensation for which deductions are governed by section 23(p).

The Regulations go on to say, however, that this provision is not intended to cover cases where, for example, compensation is deferred because of inability to pay such compensation or where the liability accrues in the earlier year, but the amount payable cannot be exactly determined until the later year.

CHAPTER XIII

INCOME AND EXPENSE PROBLEMS *

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A MOCKERY has been made of accounting principles in the way the tax law has been officially interpreted on the subject of the time for reporting income and deduction. The law (Section 41 of the Code) says that in the first instance, the taxpayer's books control. The law permits departure from the books only if it is necessary to do so in order to clearly reflect income. Accepted accounting principles are by regulation the criteria for the clear reflection of income. The exact reference in the Regulations is to "approved method of accounting." So far so good.

One of the fundamental principles in accounting is the matching of income with related cost and expense. This cornerstone has been subverted by official tax interpretation, and twisted to a rule that says that income is to be reported as early as possible and a deduction is to be taken as late as possible.

An example of weird acceleration of income, contrary to good accounting practice, is the tax rule that requires a landlord on the accrual basis to report immediately, as income, rentals collected for future years, though the rentals must be returned if the rented space or service is not made available to the tenant. Illustrative of the tax postponement of deductions, compared with timing under approved accounting methods, is the treatment of reserves for discounts, guarantees, freight allowances, maintenance obligations, etc.

* *Editor's Note:* A digest of the talk on this topic. As Mr. Seidman spoke extemporaneously a complete record of his talk is unfortunately not available.

The tax rule is based on the "claim of right" theory. The idea is that as the advance rental monies were received as a matter of contractual right, the monies are income to the landlord. That idea is repugnant to logic, economics, and morals. No honest man has income or regards as income an amount in respect to which there is an offsetting obligation to pay or serve.

The tax rule has the government advantage of insuring tax collection when the money is around. It is the old "bird-in-the-hand" notion. However, the convenience of the Treasury should count for nought when it is overcome by the legitimate interests of the taxpayer. As things now stand, there is the distortion of bunching an amount in one year as income and allowing related deductions in another year, and the twain may never meet.

The tax rule also offers in its support the assertion that the accounting viewpoint involves too much of a judgment factor, particularly in respect to deduction of reserves. Judgment, however, is implicit in all business transactions and in all concepts of income. The determination of inventories, bad debts, valuations, reek with judgment. That is far better than the arbitrary way in which the timing of income and deductions now comes off. Furthermore, the area of judgment is not a free or loose one. It can be circumscribed by the past experience of the taxpayer or of other taxpayers.

From a revenue standpoint, there is no telling how the tax rule works because revenue depends on the course of tax rates and the size of the income from year to year. Maybe the taxpayer is ahead or maybe the government is ahead. But nobody is ahead on the abhorrent usurpation of time, manpower, and money consumed by both government and taxpayer, in the vast amount of controversy and litigation that now surrounds the problem of the timing of income and deductions.

What is the answer? Obviously, the thing to do is to go back to Congress for a restatement and clarification of the law. The law should affirmatively adopt the established accounting prin-

ciple of matching income and deduction. To insure a proper statement of the law in this respect, it would be well to enlist the aid of accredited representatives of the accounting profession in review of the draftsmanship.

CHAPTER XIV

ENFORCEMENT OF SECTION 102 OF THE UNITED STATES INTERNAL REVENUE CODE

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SECTION 102 of the United States Internal Revenue Code imposes an additional corporate surtax upon corporations under certain circumstances.

The tax applies if a corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed.

The Section 102 tax is in addition to the regular corporate normal tax and surtax. Domestic and foreign personal holding companies are not subject to the tax; all other corporations regardless of size, however created or organized, are subject to its provisions if they are either formed or availed of for the prohibited purpose.

SECTION 102 NET INCOME

The tax is imposed upon the undistributed net income. It is first necessary to compute the Section 102 net income in determining undistributed net income.

The Section 102 net income in the case of a domestic corporation is computed, without the benefit of the capital loss carry-over provided in Section 117(e) and without the net

operating loss deduction provided in Section 23(s), by subtracting from the corporate net income:

1. Federal income, war profits, and excess profit taxes (other than the tax imposed by Subchapter E of Chapter 2 of the Internal Revenue Code for a taxable year beginning after December 31, 1940) paid or accrued during the taxable year to the extent not allowed as a deduction under Section 23(c); but not including the graduated income tax or surtax imposed by Section 102 or corresponding sections of prior Revenue Acts;
2. Contributions or gifts, payment of which is made within the taxable year, not otherwise allowed as a deduction, to or for the use of donees described in Section 23(o) and for the purpose therein specified;
3. Losses from the sale or exchange of capital assets which are disallowed as a deduction by Section 117(d) for the taxable year.

In computing Section 102 net income for taxable years beginning after December 31, 1941, and before January 1, 1946, the amount of income subject to the excess profits tax is deducted. For taxable years beginning after December 31, 1945, the excess profits tax has been repealed and, therefore, this deduction is eliminated.

Undistributed Section 102 Net Income

Undistributed Section 102 net income is computed by subtracting from Section 102 net income, described above, the amount of the basic surtax credit. The basic surtax credit includes the amount of dividends paid and consented to, the net operating loss credit, and the bank affiliate credit.

Section 102 net income includes interest upon obligations of the United States and obligations of a corporation organized under acts of Congress if such corporation is an instrumentality of the United States, except interest on obligations of the United States issued before September 1, 1917, and interest upon obligations issued after September 1, 1917, by the United States or its instrumentalities to the extent that such interest is wholly exempt under the acts under which the obligations were issued, from all the various taxes including normal taxes and surtaxes imposed under Chapter 1 of the Code.

Section 102 net income does not include interest on obligations of states or territories of the United States, or any political subdivision thereof, or the District of Columbia, or the possessions of the United States. The tax laws, of course, provide that dividends paid by corporations from exempt earnings are subject to income tax in the hands of the stockholders. Although interest on obligations of states or territories, etc., is not included as part of Section 102 net income, it must be considered as a part of surplus in determining whether or not earnings were unreasonably accumulated.

The tax is at the rate of 27½ per cent of the amount of the undistributed Section 102 net income not in excess of $100,000, plus 38½ per cent of the undistributed Section 102 net income in excess of $100,000.

Legislative History

The Revenue Acts of 1913 and 1916 did not impose additional taxes upon corporations but attempted to solve this problem by taxing to the shareholders their share of the current earnings of corporations which were formed or availed of for the purpose of preventing the imposition of individual surtaxes.

The Revenue Act of 1917 for the first time imposed this additional tax upon the corporation. With the exception of the years 1918, 1919, and 1920, which were governed by the Revenue Act of 1918, the tax has been on the corporation.

Section 220 of the Revenue Act of 1918 dealt with this question in a somewhat different manner than the Revenue Acts of 1913, 1916, and 1917 in that if any corporation, however created or organized, was formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, it was not subject to the regular corporate normal tax, but was subject to war profits and excess profits taxes. The latter taxes were deducted from the net income of the corporation, and the

individual shareholders were required to report for taxation their proportionate share of the remainder.

Originally in the Revenue Acts of 1913 and 1916 the tax applied only with respect to corporations "formed or *fraudulently* availed of" to prevent the imposition of individual surtaxes, with the further proviso that a showing that a corporation was a mere holding company or that corporate earnings were permitted to accumulate beyond the reasonable needs of the business—when so certified by the Commissioner—was prima facie evidence of a fraudulent purpose.

The Revenue Acts of 1917 and 1918 eliminated the word "fraudulent" but it was not until 1924 that Congress eliminated the requirement of a Commissioner's certificate that the accumulation was unreasonable.

Section 220 of the Revenue Act of 1921 contained a provision to the effect that if all the stockholders or members of such corporation agree thereto, the Commissioner may, in lieu of the regular income, war profits, and excess profits taxes imposed upon the corporation for the taxable year, tax the stockholders or members of such corporation upon their distributive shares of the net income of the corporation for the taxable year in the same manner as in the case of members of a partnership.

Section 220(e) of the Revenue Act of 1926 read in part as follows:

> The tax imposed by subdivision (a) of this section shall not apply in respect of any taxable year if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire distributive share, whether distributed or not, of the net income of the corporation for such year. . . .

Section 102(d) of the Revenue Act of 1934 changed the provisions of the Revenue Act of 1926 to read "adjusted net income" in lieu of "net income."

Adjusted net income was defined in the Revenue Act of 1934 as the net income computed without deducting for dividends received from domestic and certain foreign corporations,

but the net income was diminished by the amount of dividends paid during the taxable year.

In addition to the reporting of the pro rata shares by the shareholders the Revenue Act of 1936 imposed a further condition: that 90 per cent or more of such retained net income be included in the gross income of shareholders other than corporations.

The Revenue Act of 1938 eliminated the option of payment of surtax on pro rata shares by the individual stockholders.

The Internal Revenue Code was adopted in 1939, and the provisions of Section 102, as contained in the Revenue Act of 1938, were continued in the Code, and only minor amendments and changes in rates have been made since the Code's adoption.

Presumption

Section 102(b) provides that the fact that any corporation is a mere holding or investment company shall be prima facie evidence of a purpose to avoid surtaxes upon shareholders. Section 102(c) provides that the fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation, by the clear preponderance of the evidence, shall prove to the contrary.

Section 29.102-2 of Regulations 111 reads in part as follows:

> If the Commissioner determines that the corporation was formed or availed of for the purpose of avoiding the individual surtax through the medium of permitting earnings or profits to accumulate, and the taxpayer contests such determination of fact by litigation, the burden of proving the determination wrong by a preponderance of evidence, together with the corresponding burden of first going forward with evidence, is on the taxpayer under principles applicable to income tax cases generally, and this is so even though the corporation is not a mere holding or investment company and does not have an unreasonable accumulation of earnings or profits. However, if the corporation *is* a mere holding or investment company, then the Internal Revenue Code gives further weight to the presumption of correctness already arising from the Commissioner's determination by expressly providing an additional presumption of the existence of a purpose to avoid

surtax upon shareholders, while if earnings or profits are permitted to accumulate beyond the reasonable needs of the business, then the Code adds still more weight to the Commissioner's determination by providing that irrespective of whether or not the corporation is a mere holding or investment company, the existence of such an accumulation is *determinative* of the purpose to avoid surtax upon shareholders unless the taxpayer proves the contrary by such a clear preponderance of all the evidence that the absence of such a purpose is unmistakable.

Section 102(c) appeared first in the Revenue Act of 1938 at the time of the repeal of the undistributed profits tax, and has been continued in the Internal Revenue Code. The Senate Finance Committee in its report on the Revenue Act of 1938 made the following comment on Section 102(c):

> This subsection of the bill provides that the fact that the earnings or profits are accumulated beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax on shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary. Under existing law, an unreasonable accumulation is only prima facie evidence of the purpose to avoid a surtax upon shareholders. Consequently, it has been argued that the only effect of an unreasonable accumulation is to shift to the taxpayer the burden of going forward with the evidence relating to purpose. Under the amendment, however, it is clear that an unreasonable accumulation puts upon the taxpayer the burden of proving by the clear preponderance of all the evidence submitted that it did not have the purpose of avoidance.

In *United Business Corporation of America* v. *Commissioner of Internal Revenue*,[1] Judge Hand, speaking for the Circuit Court in regard to the presumption contained in Section 220 of the Revenue Act of 1921 (now 102) made this comment:

> A statute which stands on the footing of the participant's state of mind may need the support of presumption, indeed be practically unenforceable without it, but the test remains the state of mind itself, and the presumption does no more than make the taxpayer show his hand.

In the Bureau's Enforcement of Section 102 What Facts are Considered?

The problem of enforcement of Section 102 during the years 1936 and 1937 was reduced by reason of the surtax on undis-

[1] 62 F. (2d) 754, *cert. den.*, 290 U.S. 635.

tributed profits imposed by Section 14 of the 1936 Act (which imposed a tax on corporate profits not distributed to stockholders in the form of taxable dividends) and, further, by reason of the imposition of the excess profits tax during the years 1940 to 1945, both inclusive.

The following are excerpts from the Commissioner's statement to the press on December 13, 1934:

> No operating corporation accumulating surpluses and using the same in the business in which it is engaged should be apprehensive. As an illustration, a manufacturing company in good faith setting up surpluses for acquiring material, offsetting a fluctuation in wage scale, carrying the proper amount to offset accounts receivable, or accumulating a reasonable reserve to pay present indebtedness would not be taxed under Section 102. It would be a different matter, however, if it accumulates these surpluses to purchase stocks, bonds, and securities of other corporations. For example, a corporation in the soap manufacturing business, using the earnings to acquire a large block of bonds and securities, and with large surpluses already accumulated, should not be allowed to escape tax under this section if the additional surplus was for the purpose of expanding the business into another field, as for instance the grocery business. Nor should an automobile business be allowed to build up large surpluses for the purpose of acquiring railroad or mining properties simply because it ships its products over railroads and uses the output of mines in the manufacture of its products.

The Treasury Department Press Service release dated December 17, 1934, contains a statement made to the press on December 13, 1934, by Robert H. Jackson, Assistant General Counsel for the Bureau of Internal Revenue (now a member of the United States Supreme Court), relative to the policy of the Bureau in applying Section 102, 1934 Act, and 104, 1932 Act, to business corporations other than holding or investment companies. Mr. Jackson states in part as follows:

> Executives are also inquiring what the Treasury will regard as reasonable needs of the business in measuring corporate surplus. Congress did not lay down in advance a definite rule applicable to all cases and the Bureau of Internal Revenue is unable to do so. . . .
>
> Among other things the Bureau will consider the hazards of that business, its normal rate of expansion, any contingency against which reserves ought to be set up, any unemployment insurance or employee benefits that require

reserves, whether the surplus is actively used in the business of the corporation or is invested in lines of business foreign to its own, together with any other facts which the particular corporation desires the Bureau to consider, with the assurance that while the Bureau intends to apply the Acts just as they were written it has no purpose by interpretation to extend them beyond the intent of Congress. We believe that few executives will have difficulty in determining whether their surplus is a reasonable business surplus or whether it is withheld from stockholders for other reasons.

On July 26, 1939, the Commissioner of Internal Revenue issued Treasury Decision 4914, which, as amended on August 12, 1944, by Treasury Decision 5398, provides in part as follows:

Revenue agents are required to make a specific recommendation as to the application or non-application of Section 102 in the following instances:

(1) Corporations which have not distributed at least 70% of their earnings as taxable dividends.
(2) Corporations which have invested earnings in securities or other properties unrelated to their normal business activities.
(3) Corporations which have advanced sums to officers or shareholders in the form of loans out of undistributed profits or surplus from which taxable dividends might have been declared.
(4) Corporations, a majority of whose stock is held by a family group or other small group of individuals, or by a trust or trusts for the benefit of such groups.
(5) Corporations the distributions of which, while exceeding 70% of their earnings, appear to be inadequate when considered in connection with the nature of the business or the financial position of the corporation or corporations with accumulations of cash or other quick assets which appear to be beyond the reasonable needs of the business.

Cases Decided by the Courts in Favor of the Taxpayer

Accumulations Held to be Reasonable

A review of the decisions of the courts reveals that, in twenty cases in which the taxpayer prevailed, the facts were similar in that the stock of the corporation was closely held, and that the taxpayer claimed that the earnings were not accumulated beyond the reasonable needs of the business, but were accumulated in some cases for the expansion of the business and in

others for both expansion of the business and to finance additional facilities.[2]

In *Universal Steel Company, supra,* petitioner contended that it had need for additional equipment which would cost from $75,000 to $100,000. The Commissioner contended that no steps toward securing this equipment had been taken. The Court found the petitioner had shown it was seriously handicapped by lack of equipment, that it had taken steps to secure priorities but that the War Production Board had refused to grant the necessary priorities. The Tax Court held for petitioner.

In *Walkup Drayage and Warehouse Company, supra,* the Commissioner contended that petitioner could have borrowed money to pay a dividend and that there is nothing unusual about a corporation borrowing cash from a bank for use in the making of a dividend distribution and then borrowing further for the needs of the business. The Court pointed out that the statute in question was not intended to force the distribution of earnings and profits necessary for the proper operation of the business, but was intended only to prevent the accumulation of earnings and profits for the purpose of avoiding the imposition of surtax upon the shareholders. The Tax Court held for petitioner.

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[2] *Industrial Bankers Securities Corp.,* 104 F. (2d) 177.
Dill Manufacturing Co., 39 B.T.A. 1023 (non-acquiesced in by Comm.).
California Motor Transport Co., Ltd., T.C. Memo. Dec. CCH 13,154-M.
Bosch Brewing Co., T.C. Memo. Dec. CCH 12,592-M.
Howard Flint Ink Co., T.C. Memo. Dec. CCH 12,591-B.
L. R. Teeple Co., 47 B.T.A. 270.
Dietze and Co., Inc., T.C. Memo. Dec. CCH 12,892-A.
General Smelting Co., 4 T.C. 313.
Wean Engineering Co., Inc., T.C. Memo. Dec. CCH 13,394-M.
Smokeless Fuel Co., T.C. Memo. Dec. CCH 13,499-M.
T. Smith and Sons, Inc., T.C. Memo. Dec. CCH 13,474-M.
Lane Drug Co., T.C. Memo. Dec. CCH 13,895-M.
Baker and Co., Inc., T.C. Memo. Dec. CCH 13,518-M.
Walkup Drayage and Warehouse Co., T.C. Memo. Dec. CCH 14,656-M.
Universal Steel Co., 5 T.C. 627.
Syracuse Stamping Co., T.C. Memo. Dec. CCH 14,489-M.
Gus Blass Co., T.C. 15.
Lion Clothing Co., T.C. 1181.
William C. Atwater & Co., Inc., 10 T.C. 1948.
J. L. Goodman Furniture Co., 11 T.C. 1948.

The Commissioner made the same contention in the case of *General Smelting Company, supra,* and the Tax Court reached the same conclusion.

In *Lane Drug Company, supra,* the Commissioner urged that if petitioner had distributed its net income, its principal shareholder, who owned 70 per cent of the stock, would have paid a tax of $43,301.65 instead of $8,358.24. The Court pointed out that this fact doubtless justified the respondent in closely scrutinizing the petitioner's activities. It does not, however, per se, establish the prohibited purpose. It is but an evidentiary fact to be weighed and we do not overlook its significance.

The Court stated that as an operating company petitioner had the right to legitimate expansion, sufficient storage facilities, an inventory reasonably adequate to meet its increasing volume of business, and to maintain its credit, that the record disclosed no evidence of excessive inventories, no loans to any officer or stockholder, no investment in stock or bonds of other corporations, and no intent to expand its collateral or unrelated lines of business, nor to unreasonably expand within its own field. Under these circumstances the Court was reluctant to substitute its judgment for that of the directors who are legally charged with the duty of weighing and deciding this important economic question. The Tax Court held for petitioner.

In *Lion Clothing Company, supra,* the Court made the following comment:

> We do not think it can be said that the taxpayer's earnings were accumulated beyond the reasonable needs of the business where it is shown that the purpose of their accumulation is to retire mortgage indebtedness, to make improvements which will add to the convenience and efficiency of operations of the business, to expand operations by purchasing the interest of concessionaires, to accumulate some cash reserves as a bulwark against future depressions and to meet unknown risks of the war and postwar periods.

In the case of *Gus Blass Company, supra,* a rather unique situation was presented. Petitioner claimed that the accumulations for its fiscal year ended January 31, 1941, were necessary to finance the construction of a new building at a cost of $750,-

000, the plans for which were somewhat indefinite. The Tax Court pointed out that even if the plans were definite the petitioner had accumulated from past earnings federal, state, and municipal bonds and corporate stocks aggregating $1,102,-980.07, which was not necessary in the operation of its department store, that it still could have distributed the earnings of the fiscal year ended January 31, 1941, without lessening its ability to finance a $750,000 project.

The Tax Court found that the evidence in its opinion warranted the conclusion that the petitioner in the fiscal year ended January 31, 1941, had permitted its earnings and profits to accumulate beyond the reasonable needs of the business, which established the presumption under Section 102(c) that it was the purpose of petitioner to avoid surtax upon its stockholders for the year ended January 31, 1941. But the Court stated that this presumption can, under further provisions of Section 102(c), be overcome by a clear preponderance of the evidence to the contrary.

The petitioner's directors, at a meeting in January, 1941, decided to revert to the former policy of postponing the payment of dividends until after the receipt of the auditor's final report as to its earnings for the fiscal year ended January 31, 1941. Petitioner's earnings, after taxes, for its fiscal year ended January 31, 1941, were $240,134.70. On March 12, 1941, after the close of the fiscal year ended January 31, 1941, and after receipt of the auditor's report, the petitioner declared a dividend of $239,690 which was paid on April 20, 1941; and after the next fiscal year ended January 31, 1942, petitioner declared on March 12, 1942, and paid on June 10, 1942, a dividend of $239,690. Petitioner's net profit after taxes for the fiscal year ended January 31, 1942, was $252,175.33. The record showed that 94 per cent of the dividend paid on April 20, 1941, was paid to shareholders who filed their returns on the calendar year basis and reported their dividends so received in 1941.

The Court held that petitioner had overcome the presump-

tion of Section 102(c) and that petitioner was not availed of in the fiscal year ended January 31, 1941, for the purpose proscribed by Section 102(a).

Accumulations Held to be Unreasonable

It appears that in fifteen cases the courts decided that the petitioners had unreasonably accumulated their earnings and, as a consequence, were liable for the tax under Section 102. In some of these cases the taxpayers had made loans to stockholders; had made investments in unrelated businesses; accumulations were made for contingencies which the court held were too remote; the taxpayer voluntarily used accumulated earnings to purchase all its outstanding preferred stock.[3]

In *J. M. Perry and Company, Inc., supra,* petitioner contended that it required some $250,000 for working capital and financing growers who were its customers. The evidence disclosed that contemplated alterations and repairs were not made and the total amount used in financing growers in 1935 and 1936 was $35,000. Petitioner made various investments not related to its business, purchased mining stock which it sold at a profit of $47,995.29, purchased forty-nine residential lots and started constructing houses thereon at a cost of from $4,000 to $5,000 each, and purchased a bank building which was sold to its principal stockholder at cost—the sale price was not paid but carried as accounts receivable on petitioner's books. It made various loans to individuals not connected with its business

[3] *National Grocery Co.*, 304 U.S. 282, *rehear. denied,* 305 U.S. 669.
J. M. Perry & Co., T.C. Memo. *aff'd,* 120 F. (2d) 123.
Wilkerson Daily Corporation, 42 B.T.A., *aff'd,* 125 F. (2d) 998.
United Block Co., Inc., T.C. Memo., *aff'd,* 123 F. (2d) 704, *cert. denied.*
Gibbs & Cox, Inc., T.C. Memo., *aff'd,* 147 (2d) 60.
Becton, Dickinson & Co., T.C. Memo., *aff'd,* 134 F. (2d) 354.
World Publishing Co., a corporation 72 F. Supp. 886, *aff'd,* 10th Circuit 7-15-48.
Whitney Chain & Mfg. Co., 3 T.C. 1109, *aff'd,* 149 F. (2d) 936.
John F. Boyle Co., T.C. Memo. Dec. CCH 14,313-M.
Albert L. Allen Co., Inc., T.C. Memo. CCH 14,261-M.
Christman Veneer & Lumber Co., T.C. Memo. CCH 14,570-M.
Semagraph Co., T.C. Memo., *aff'd,* 152 F. (2d) 62.
Southland Industries, Inc., T.C. Memo. CCH 15,467-M.
Colonial Amusement Corp., T.C. Memo. CCH 16,545-M.
McCutchin Drilling Co. v. *Comm.,* 143 F. (2d) 480.

aggregating $100,000, and loaned to Perry, its principal stockholder, $30,000. The Board found that petitioner was liable for the additional tax and the Circuit Court sustained this decision.

In *Wilkerson Daily Corporation, Ltd., supra,* Wilkerson testified that the purpose of permitting petitioner's gains and profits to accumulate instead of being divided or distributed was to enable petitioner to expand its corporate business and to provide a reserve for certain contingencies. The Board did not credit this testimony. Instead, the Board noted that the expansion plans testified to by Wilkerson were never carried out, and that the failure to carry them out was not satisfactorily explained. To the Board, moreover, the purpose mentioned by Wilkerson seemed inconsistent with petitioner's action in making loans to Wilkerson in the sum of $69,929.54 in the fiscal year ended July 31, 1936. The Board's decision was affirmed by the Circuit Court.

In *Becton, Dickinson & Company, supra,* the petitioner's minutes disclosed that its president was directed to investigate and report on the cost of a contemplated addition. The president testified that five months after the close of the taxable year he began the investigation. The Board, in sustaining the Commissioner's proposed deficiency, said:

> All other evidence is subsequent to this time and none of it actually convinces us that petitioner ever had in the taxable year any fixed intention of building the "contemplated" addition. . . . We do not believe that a mere nebulous intention to expand the plant, which is the most the evidence here shows, is sufficient to sustain petitioner's contentions in this proceeding. We also believe that even if the "contemplated" addition had been made all, or at least most, of the earnings could have been distributed without jeopardy to petitioner's financial position.

In *Whitney Chain Manufacturing Company, supra,* the petitioner retained $70,000 of its 1939 earnings for future expenditures. During 1939 to 1942 petitioner expended $585,000 for additional facilities and conversion to war production. The Tax Court pointed out that petitioner might have distributed the $70,000 either (1) by declaring a cash dividend conditioned

upon the shareholders applying the sums received in reduction of their indebtedness; or (2) by declaring a dividend in kind, payable by the cancellation of the debt of the shareholders to the extent of the retained earnings. A third possibility was the declaration of a dividend to the extent of the retained earnings, payable in stock of Hanson-Whitney Machine Company in which petitioner held stock carried on its books at a figure of $380,000, and for which there was no ready market in 1939. Any one of the three methods would have distributed the earnings without reducing the quick assets available for use in the corporation's business.

In *Albert L. Allen Company, supra,* the Tax Court held that petitioner was not justified in retaining its earnings because it feared its principal source of insurance business would be lost by reason of proposed changes in the Pennsylvania Workmen's Compensation Act.

In *World Publishing Company, supra,* the facts as to the estimated costs of the expansion are somewhat vague, but one estimate for the new buildings was $635,000 and for the press and accessory equipment $300,000, of which another taxpayer was to pay one-half of the cost of the press. The accumulations challenged were for 1942 and 1943. The contract for the press and the down payment were made in 1945.

The District Court held the plaintiff could not have used the accumulation for its planned expansion during 1942, 1943, or within a reasonable time thereafter, and as there was adequate surplus previously accumulated to meet all reasonable demands, the plaintiff had failed to overcome by a preponderance of the evidence the finding of the Commissioner and the tax must stand.

The Tenth Circuit on July 15, 1948, sustained the District Court. Judge Phillips wrote a dissenting opinion. He pointed out that the plaintiff at the end of 1942 had quick assets, consisting of stock, cash, and bonds of $631,252.57, and current liabilities of $67,600.78, leaving an excess of $563,651.79 of quick assets over current liabilities; and at the end of 1943

the quick assets were $859,099.53 and current liabilities $187,-837.93, leaving an excess of $671,261.60 of quick assets over current liabilities. He further pointed out that had plaintiff distributed in 1942 the $80,430.59, held by the Commissioner to be taxable under Section 102, it would have had $483,221.20, or less than the then grossly inadequate estimate of the cost of the new building and the new press and accessory equipment, leaving no liquid funds for working capital; and with the addition of $70,997.44 at the end of 1943 the amount was still below the cost of the building and equipment even if the other taxpayer should pay half the cost of the new press and accessory equipment. Judge Phillips stated that the lower court erred in giving consideration to earned surplus, and that the cost of the new building and equipment would have to be paid out of quick assets, not out of earned surplus.

In *McCutchin Drilling Company* v. *Commissioner, supra,* the Circuit Court made this comment:

> Petitioner argues that it was entitled to adequate working capital both to finance its current operations and to provide for anticipated expansion. It says that shallow well drilling in which it was engaged had become less attractive because of the decreased returns and that it planned to enter the deep well drilling business which offered very attractive returns, that such drilling required the purchase of expensive machinery, and that at least $100,000 to $150,000 in cash, as found by the Tax Court, was needed to operate economically.
>
> The argument is not persuasive for the reason (1) that no deep wells were drilled or contracted for by it during the fiscal year ended September 30, 1941; (2) that it declared a stock dividend of $125,000 and a cash dividend of $25,000 during the fiscal year notwithstanding that its earnings were less than $4,500; and (3) that it financed without extra charge throughout its fiscal year McCutchin's purchase of supplies and the drilling of his wells. The statute, we think, contemplates immediate need associated with business in hand, apparently absent under the facts of this case.

Publicly-Owned Operating Companies

The thirty-five foregoing cases were all closely held operating companies. Two cases [4] involving a publicly-owned operating

[4] *Trico Products Corp.*, 46 B.T.A. 346, 137 F. (2d) 424, *cert. den.*, 320 U.S. 799. *Trico Products Corp.* v. *McGowan*, 67 F. Supp. 311, *aff'd,* Circ. Ct. (July, 1948).

company were decided in favor of the government. One was decided by the Board of Tax Appeals, the other by the District Court; and both were affirmed by the Circuit Court. The case tried before the Tax Court involved the years 1934 and 1935, and the one tried before the District Court involved the years 1936 and 1937. The facts in both cases, except for a variation in the figures, were the same.

Petitioner's business was the manufacture and sale of automatic windshield wipers. In 1928 it had from 1,200 to 1,500 stockholders, and in 1935 approximately 2,200 stockholders. In 1927 the corporation was recapitalized with 675,000 shares of common stock without par value. The bankers purchased 175,000 shares and twenty-one stockholders 50,000 shares, all classed as free shares. The balance of 450,000 shares was purchased by the twenty-one stockholders and was not to share in dividends until after the 225,000 free shares had received $2.50 per share in any one year. The restricted shares might be released from time to time in accordance with a formula which required an increasing amount of annual earnings per share where the last share to be released would require annual earnings of $9.00 per share on all its stock, or a total of $6,075,000.

Petitioner stated that its *principal* reason for retention of earnings was to build up an invested capital which, by increasing total earnings, would enable the controlling stockholders to release a larger amount of stock from the restrictions placed on it by the bankers.

The Board of Tax Appeals said:

> This may have been a natural course for the majority to cause the corporation to adopt for their own private ends, but it had nothing to do with needs of the business, and in fact to the extent that it benefited the controlling stockholders there was a corresponding detriment to the remainder. . . .
>
> Although it was repeatedly asserted that the benefit of the stockholders, from the standpoint of saving taxes, was never discussed or referred to as an element either in the original plan of recapitalization or in the policy adopted by the company of limiting its dividends to the minimum preferred amount, the pecuniary weight of the tax savings was so overwhelmingly greater than the benefit derived by the majority stockholders from the re-

lease of shares that it is difficult to believe that it was only the latter and never the former to which they allowed their purposes to stray. . . .

The Circuit Court, when reviewing the Board's decision, called attention to the fact that petitioner had invested in operating assets from $5,229,805.72 in 1929 to $7,271,086.05 in 1935, and had increased its investments in securities from $1,097,571.40 to $6,859,067.96 during these years. Its investments in United States, state, and municipal bonds and stocks and other investments in 1936 aggregated $9,036,743.27; in 1937, $10,192,815.47; and in 1941, $18,949,883.88. The Circuit Court said:

> It was apparent that the building up of this security investment instead of the distribution in dividends of a substantial part of the funds so used did prevent the imposition of surtaxes in the years in question upon at least some of the stockholders of petitioner.

CONSTITUTIONALITY

Provisions in prior laws comparable to the present provisions of Section 102 have been upheld as constitutional.[5]

SUGGESTED CHANGES IN SECTION 102

The Special Study Committee of the Committee on Ways and Means, United States House of Representatives (Magill Committee) recommended, under date of November 3, 1947, that Section 102 of the Internal Revenue Code be amended in the following particulars:

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[5] *Keck Investment Co.* v. *Comm.*, 77 F. (2d) 242, *cert. den.*, 296 U.S. 633.
Helvering v. *National Grocery Co.*, 304 U.S. 282, *rehear., den.*, 305 U.S. 669.
Almours Securities, Inc. v. *Comm.*, 91 F. (2d) 427, *cert. den.*, 302 U.S. 765.
B & L Investment Co. v. *Comm.*, 33 B.T.A. 857, *aff'd*, 84 F. (2d) 721, *cert. den.*, 299 U.S. 588.
William C. DeMille Products, Inc., 30 B.T.A. 827.
R. L. Blaffer v. *Comm.*, 103 F. (2d) 487, *cert. den,,* 308 U.S. 576, *rehear., den.*, 308 U.S. 635.
A. D. Saenger Inc. v. *Comm.*, 33 B.T.A. 135, revised on other grounds 84 F. (2d) 23, *cert. den.*, 299 U.S. 577.
Bastian & Bros. Co. v. *McGowan*, 32 F. Supp. 93, *aff'd*, 113 F. (2d) 489, *cert. den.*, 311 U.S. 702.
Williams Investment Co. v. *U.S.*, 3 F. Supp. 225.
United Business Corporation of America v. *Comm.*, *supra.*

(1) The Commissioner should have the burden of proof that profits have been unreasonably accumulated.
(2) The tax should apply only to that part of the undistributed Section 102 net income which is unreasonably accumulated.
(3) Dividends paid within 75 days after the close of its taxable year may, at the taxpayer's election, be deducted in computing Section 102 net income for such year.

Section 125 of H.R. 6712, which passed the House of Representatives of the federal Congress in 1948 but was not reached by the Senate before the adjournment of the Eightieth Congress, amended Section 102 to provide that in any case in which the Commissioner proposes to determine a deficiency in respect to this type of additional tax, he may, prior to the mailing of a notice of deficiency, give the taxpayer notice by registered mail of an opportunity to file with the Commissioner a statement of the grounds on which the taxpayer relies as establishing that the earnings or profits of the corporation have not been accumulated beyond the reasonable needs of the business; that if a statement of such grounds with supporting facts is filed with the Commissioner within thirty days, the burden of proof with respect to the issue as to whether earnings or profits have been permitted to accumulate beyond the reasonable needs of the taxpayer shall be upon the Commissioner, provided the taxpayer files a petition with the Tax Court of the United States and the taxpayer in such proceedings does not rely upon any grounds with respect to such issue other than those presented the Commissioner in his statement.

The amendment further provides that if the Commissioner mails a notice of deficiency for such additional tax without giving the taxpayer an opportunity to file such statement, the Commissioner shall have the burden of proof in any proceedings before the Tax Court of the United States with respect to such issue.

The amendment also excludes long-term capital gains from Section 102 net income; and provides that dividends paid within seventy-five days after the close of the taxable year may, with certain limitations, at the election of the taxpayer, be

deducted in computing Section 102 net income for the prior taxable year.

It is contended by some that if this amendment is enacted it would cripple the enforcement of Section 102. In other words, if the taxpayer filed the notice, as above provided, the Commissioner would be unable to prove that the earnings or profits had been permitted to accumulate beyond the reasonable needs of the business.

Unless the Commissioner is able to prove that the earnings have been permitted to accumulate beyond the reasonable needs of the business, a fair question to ask is: Why should the taxpayer be subjected to this additional tax? The Commissioner should have no difficulty in sustaining this burden in cases of accumulations by closely held operating companies where the records show that the principal stockholders borrowed large sums from the corporation or that the corporation invested large sums in securities that bore no relation to the business of the corporation.

The *Trico Products Corporation* case, *supra,* was tried and decided under the Revenue Acts of 1934 and 1936 and before the enactment of subsection (c) of Section 102, which provided, in substance, that the fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders, unless the corporation by the clear preponderance of the evidence shall prove to the contrary.

The Revenue Acts of both 1934 and 1936 provided that the fact that the earnings or profits of a corporation were permitted to accumulate beyond the reasonable needs of the business shall be prima facie evidence of a purpose to avoid surtax upon the shareholders.

FORM 1120 FOR 1946

Form 1120 for the year 1946 contained question number 8 on page 3, which read as follows:

If the total of line 1 of Schedule M, page 4, is less than 70 per centum of the earnings and profits for the taxable year, state reasons for retention of such earnings and profits.

On December 5, 1947, George J. Schoeneman, Commissioner of Internal Revenue, made a statement of administrative policy with regard to Section 102 of the Internal Revenue Code, which reads in part as follows:

. . . . Section 102, or a substantially equivalent provision, has been in the income tax law since the modern income tax was adopted in 1913. It never has been and is not now the policy of the Bureau of Internal Revenue to apply this provision to any corporation unless it is withholding from its stockholders surplus earnings clearly in excess of the reasonable needs of the business and for the purpose of enabling stockholders to avoid personal income taxes. In determining whether surplus is retained for business purposes, it is our unvarying policy to give due consideration to the judgment of the corporation's own management as to what sums are needed for working capital, expansion of facilities, sinking fund for debt retirement, contingency funds to cover employee benefits, and similar bona fide business and legal needs. In all questionable cases, it is our policy to give the corporation's management an opportunity to explain the purpose of its surplus retentions before applying Section 102. We believe the administrative record of the past 35 years provides ample assurance that Section 102 has not been, and is not being, applied so as to affect adversely the bona fide operations or conduct of any business.

To some extent, misunderstanding appears to have arisen because the 1946 corporate tax return asked corporations to state whether they had distributed at least 70 per cent of their earnings to stockholders. This question has been deleted for the 1947 return.

Cases Decided by the Courts Since 1913 In Which the Additional Tax Was in Dispute

The statistics of income published by the Treasury Department do not show separately the amount of the additional tax collected under Section 102 or prior statutes. There are eighty-nine cases cited in USCA and Commerce Clearing House Standard Federal Tax Reports which have been decided by the courts in which this question was involved. An analysis of these cases discloses some rather interesting facts.

During this same period all corporations reported net incomes of $163,645 billion and paid federal income and excess

CASES DECIDED SINCE 1913

	Decision		Taxes in Dispute
	For Commissioner	Against Commissioner	
Holding companies	17		$10,852,107.67
Holding companies		0	0
Closely held operating companies	28		1,707,078.46
Closely held operating companies		42	4,086,696.75
Publicly-owned operating companies	2		3,161,540.92*
Publicly-owned operating companies		0	0
Total	47	42	$19,807,423.80

* These two cases are *Trico Products Corporation, supra.*

profits taxes of $71,332 billion and net cash dividends of $98,-195 billion, which was $5,882 billion in excess of earnings.

CORPORATE INCOME, TAXES AND DIVIDENDS
ALL REPORTING CORPORATIONS

Calendar Years 1920–1944
(In Millions of Dollars)

Year	Income Before Federal Income Taxes*	Federal Income and Excess Profits Taxes	Net Income After Taxes	Net Cash Dividends	Net Income Retained
1920–1929	$ 61,375	$10,839	$50,536	$39,697	$10,839
1930–1939	7,894	7,710	184	36,687	*36,503* (deficit)
1940–1944	94,376†	52,783	41,593	21,811	19,782
Total	$163,645	$71,332	$92,313	$98,195	*$5,882* (deficit)

* Income excluding dividends received from domestic corporations and interest on wholly tax exempt bonds.
† Preliminary.
Source: United States Treasury Department.

These figures would indicate that corporations as a whole were not unreasonably accumulating their earnings; in fact, the aggregate dividends paid exceeded the net income after taxes.

Of the eighty-nine cases, forty-two cases decided for the taxpayer and twenty-eight cases decided for the Commissioner (a total of seventy) involved closely held operating companies. The seventeen holding company cases were for taxable years prior to 1935, and if the Personal Holding Company Acts of 1935 and 1937 had been in effect at that time most of these cases would be eliminated from any consideration under Section 102. Of the $10,852,107.67 collected from holding companies, $5,010,120.70 was collected from one taxpayer, *Chicago Stockyards Company, supra,* and $2,061,021.98 from another.

The above figures do not reflect the amount of additional tax, if any, which was paid for subsequent years by the forty-six taxpayers in cases in which the decision was for the Commissioner; the amount of tax paid by agreement between the Commissioner and the taxpayer in other cases; the amount of tax paid by stockholders upon dividends received from corporations declared by the corporation through fear of the consequences of Section 102; and the amount of tax paid by stockholders by the inclusion of their pro rata shares of the corporation's net income in their returns under prior provisions of law.

If we eliminate the amount of tax collected from the seventeen holding companies, the Commissioner has prevailed in thirty cases involving operating companies, and the total tax yield was $4,868,619.38. Of this sum twenty-eight cases yielded the sum of $1,707,078.46, and in these twenty-eight cases the largest amount of tax in dispute was $477,322.81. The amounts collected seem rather insignificant when it is kept in mind that they cover taxable years from 1920 to 1944.

What ill effect this broad statute has had on the economy of the country is anyone's guess.

Conclusions

There appears to be a mistaken idea that Section 102 provides two tests: (1) the purpose, and (2) the unreasonable accumulation.

The Commissioner's interpretation of the Revenue Act of 1918 was that the application of Section 220 of the statute depends upon the two elements of (1) purpose to escape the surtax, and (2) unreasonable accumulation of gains and profits.[6] This provision was deleted by the regulations issued under the Revenue Act of 1921.[7] The present regulations provide that a corporation is subject to taxation under Section 102 if it is formed or availed of for the *purpose* of preventing the imposition of surtax upon shareholders through the medium of permitting earnings or profits to accumulate, even though the corporation is not a mere holding or investment company and does not have an unreasonable accumulation of earnings or profits. On the other hand, the fact that a corporation is a holding or investment company or has such an accumulation is not absolutely conclusive against it if, by clear and convincing evidence, the taxpayer satisfies the Commissioner that the corporation was neither formed or availed of for the purpose of avoiding the individual surtax.[8]

Under the language of the statute, the forbidden purpose (of preventing surtax on shareholders by corporate accumulations) is the fulcrum of the tax. If the corporation is *formed* for the forbidden purpose, the tax applies without regard to other considerations, and under the statutory language would continue to apply in every year of the corporate existence in which Section 102 net income could be identified. If the corporation, though formed for a proper purpose, is *availed of* in any taxable year for the forbidden purpose, the tax applies in that taxable year.

Theoretically, the forbidden purpose may exist and the tax may consequently be imposed even though the corporation is not a mere holding or investment company and even though there is no accumulation of earnings or profits beyond the reasonable needs of the business. In practice, however, such a

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[6] Regulation 45, Article 352.
[7] Regulation 62, Article 352.
[8] Regulation 111, Section 29.10-2.

situation would arise only in extreme and unusual cases, and in the absence of these special circumstances, no occasion for the imposition of the tax would ordinarily be found to exist. Hence, whatever the theory, the tax in its major applications becomes one upon unreasonable accumulations, with the added feature that when applied it applies indiscriminately to all accumulations in the taxable year, whether reasonable or unreasonable.

A statute imposing a tax upon purpose and requiring presumption upon presumption to implement its enforcement has at best a dubious place in the tax structure. A tax evidently directed at unreasonable accumulations which also taxes reasonable accumulations overreaches its purpose. A tax which constitutes a continuing threat to reasonable and necessary business decisions is apparently in need of repeal or modification. Consideration of the foregoing matters, including the history of this enactment in the courts, prompts the question: Is Section 102 necessary except for mere holding and investment companies?

In the case of publicly-owned operating companies there are, apart from the tax laws, operative factors which effectively establish a reasonable balance between earnings and distributions.

On the one hand the directors have reasons for distributing the earnings. First, they owe a duty to the stockholders not to retain an unreasonable amount of current earnings. Second, in this period of scarcity of risk capital, if it becomes necessary to raise additional capital through the sale of securities, the corporation with a good earnings record and a fair and consistent dividend policy should have less trouble in securing the necessary capital, whether raised through the sale of common or preferred stocks.

On the other hand the directors also have reasons, within legitimate limits, to withhold distributions for proper business purposes. In the discussions preliminary to enactment of the Revenue Act of 1917 it was pointed out to the Senate Finance

Committee that before income taxes were imposed by the United States and before there was any possible tax advantage to be gained by the retention of earnings, it was the universal custom and practice of corporations to retain a large part of their annual earnings for maintenance, betterments, extensions, and replacements; and also that it was the experience of the business world from the beginning of corporate existence, both here and in other countries, that a corporation which made a practice of distributing all of its annual earnings was on the road to bankruptcy.[9] These observations are still valid.

In spite of the assurance given by Mr. Schoeneman's press release of December 5, 1947, the directors of many publicly-owned operating companies are greatly disturbed over the additional tax that may be imposed upon their companies several years after they have decided to retain a part of the companies' earnings for reasons which they believe to be proper. They are further disturbed about what personal liability they may incur if it is decided that the additional tax is applicable to their companies. This fear arises from the event of a suit brought by minority stockholders of a company which was involved in one of the cases decided in favor of the Commissioner.[10] These stockholders brought an action against the directors, officers, and controlling stockholders, charging that the corporation's accumulations, in excess of $23,000,000 in 1941, were not needed in the business of the corporation and had subjected it to Section 102 taxes for the years 1934 to 1945, inclusive, in the aggregate amount of $9,825,612.54. The action was founded in tort and was settled by a stipulation whereby the defendants agreed to pay the corporation $2,390,000, and an additional dividend was declared. This settlement was approved by the New York Supreme Court.

The courts have decided that the following reasons were sufficient for the accumulation of corporate earnings or profits:

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[9] Mr. Simmons—discussion—Senate (Cong. Rec. Vol. 55).

[10] *Mahler, et al* v. *John R. Oeschei, et al* and *Trico Products Corp.* decided December 12, 1947, File No. 28,485, Supreme Court of the State of New York, New York County.

1. To carry additional accounts receivable and inventory.
2. To retire preferred stock in accordance with its terms, and bonded indebtedness.
3. To construct new buildings and equipment.
4. To continue and complete a program of expansion.
5. To provide for losses arising from contingencies foreseeable in the future.
6. Additional working capital.

Where a corporation has a definite need for the retention of current funds a record should be made in its directors' minutes or some other permanent place so that it will be able to demonstrate at a later date that earnings were not accumulated for some nebulous, vague, and unspecified purpose. If additions are to be made to plant and equipment, engineer's estimates, plans, blueprints, and drawings should be maintained as evidence of the intention to construct such plant or equipment. It would seem that records prepared at the time dividends are declared or accumulations retained are much more convincing than statements prepared at the time the revenue agent casts a critical eye on surplus retentions.

In the case of closely held operating companies the Department looks with suspicion upon large cash reserves, investments in securities with no related business purpose, loans to stockholders, etc., and in all such cases the courts sustained the Commissioner's assertion that the earnings were retained for the prohibited purpose.

The courts have recognized that corporations should be permitted to grow. In the statement of the Commissioner of Internal Revenue to the press on December 13, 1934, he made the comment that a corporation engaged in one line of manufacturing business should not be allowed to escape the tax under this section if its earnings were used to expand in another field. And the court, in the case of *Lane Drug Company, supra,* made the comment that the record in that case disclosed no evidence of excessive inventories, no loans to any officers or stockholders, no investments in stock or bonds of other corpora-

tions, and no intent to expand its collateral or unrelated lines of business nor to unreasonably expand within its own field.

It is not clear what the court had in mind about expanding the corporation's collateral or unrelated lines or unreasonably expanding within its own field. This would inferentially lend some support to the Commissioner's statement of December 13, 1934. There appears to be no basis for such a holding in the statute.

It would appear that in a free economy a corporation should be permitted to engage in any lawful undertaking and not be subject to the additional tax under Section 102 if it uses its earnings in purchasing a lawful business or expanding into unrelated lines. This would not mean that a corporation should be permitted to accumulate its earnings for the prohibited purpose during a period of several years and thereafter use the accumulated surplus in purchasing or expanding into an unrelated business, but a corporation with a definite plan of purchasing or expanding into an unrelated business should be permitted to retain its earnings and profits for that purpose.

Congress should amend Section 102 so that it will be applicable only to mere holding or investment companies. If Congress does not so amend Section 102, the provisions of H.R. 6712 should be enacted at the earliest possible date, and these provisions should be expanded so that the same burden of proof is placed upon the Commissioner in cases tried in the District Court or the Court of Claims. This amendment should also provide that the tax is applicable upon only that part of the earnings of the corporation found to be unreasonably accumulated.

CHAPTER XV

ADMINISTRATION OF EXCESS PROFITS TAX RELIEF PROVISIONS

HENRY J. MERRY

Chairman, Excess Profits Tax Council, Bureau of Internal Revenue

THE SUBJECT assigned to me is "The Administration of Excess Profits Tax Relief Provisions." This is a subject which concerns only corporations and only the taxable years 1940 to 1945. The tax liabilities for those years are still under consideration in many instances because of the novel and complex nature of many of the provisions of the excess profits tax law, and it probably will be some years before all excess profits tax problems have been solved. We are considering, accordingly, a subject which has current interest even if there is no revival of the excess profits tax.

The relief provisions particularly are of present-day importance, not merely because of the discussion of new excess profits tax law, but also because their applicability to many situations has not yet been decided. There are several relief provisions but the most important ones are those referred to as Section 721 and Section 722. These provisions are rather unusual and they give rise to inquiries which are outside the customary income tax investigations. Most tax controversies involve the question of how much income a corporation actually has earned. The relief provisions are concerned also with the question of why income was or was not earned.

Sections 721 and 722 have some similarities but they operate in opposite ways. The excess profits tax was, briefly, a tax on the amount of taxable income which exceeded a credit termed the

"excess profits credit." Section 721 operates to provide relief by reducing the amount of taxable income through a process of attributing it to some other taxable year on the theory that it was earned in the other year. Section 722, on the other hand, operates to provide relief by increasing the credit, on the theory that the credit does not reflect an adequate standard of normal earnings.

Fundamental Aspects of Excess Profits Tax Administration

Our interest necessarily concerns Section 722 because the administration of that section is the sole function of the Excess Profits Tax Council. The administrative problems unique to that unit of the Bureau of Internal Revenue arise from the essential characteristics of Section 722. Let us consider briefly its fundamental aspects.

The primary objective of the Excess Profits Tax subchapter of the Internal Revenue Code, which was enacted in 1940 and continued for six years, was to raise large amounts of revenue by taxing defense or war profits. The excess profits tax law, however, did not use the term "war profits" or any similar expression in describing the income to be taxed. The question of what constitutes war profits certainly is an imponderable and we can be happy that Congress did not use such a term as a basis of classification.

The method which Congress did adopt to achieve the general objective was that of taxing all profits in excess of a credit. Corporations which were in existence prior to January 1, 1940, were permitted a choice of two methods of computing the credit. One, termed the "invested capital method," permitted a credit represented by a percentage of invested capital. The second, termed the "income method," was based primarily upon the average earnings for the years 1936 to 1939, inclusive. Various rules were prescribed in Sections 711 and 713 for determining the average earnings. The result was called "ABPNI" (Average Base Period Net Income). It should be kept in mind

that ABPNI is a statutory concept. It may be viewed generally as a standard of earnings based upon experience prior to 1940.

Section 722 provides that under certain circumstances a different standard shall be used in place of ABPNI. The Section 722 standard of earnings likewise is based upon pre-1940 experience, although in many instances the experience is constructive rather than actual. It is accordingly related to the income method as distinguished from the invested capital method. The standard of earnings under Section 722 is called "normal earnings" or CABPNI (Constructive Average Base Period Net Income). These terms are synonymous.

Sections 711 and 713 contain specific provisions for determining ABPNI, and the determination of such amount is similar to a regular tax accounting computation. Section 722, however, contains only a few provisions indicating how CABPNI should be determined, with the result that the determination of such amount under 722 involves a selection of methods. The CABPNI is described in the statute as a "fair and just amount representing normal earnings." The principal provision indicating how such an amount is to be determined is a negative one to the effect that no events or conditions occurring or existing after December 31, 1939, shall be considered. There are two exceptions to this rule but they are of a limited nature.

Under the general rule, if I may call it that, the determination under Section 722 is based upon the actual or constructive earnings experience of the taxpayer prior to 1940, and is computed within the framework of a base period which usually consists of the years 1936-1939. This four-year period was referred to in a 1942 Senate Committee Report as a period of moderate prosperity for business in general. The actual experience during the base period is the basis of the computation but there is eliminated the effect of those events or conditions which are of such an unusual nature that they would cause the average experience for such years to be distorted. Likewise, there are to be considered changes, prior to 1940, in the character of the business, and changes which had a relatively perma-

nent effect upon the earning power of the corporation prior to 1940.

The computation of CABPNI, accordingly, involves ascertaining what a corporation would have done under conditions which are at least partly, and sometimes entirely, hypothetical. This is a new type of analysis for revenue agents as well as for most lawyers and accountants. The unique character of the problem accounts in large measure for the considerable amount of time that must be spent in analyzing cases and for the diversity of opinion with respect to the methods to be used. It also accounts for the large difference between opinions as to the amount of relief allowable in specific cases. As time goes on, however, these differences seem to be narrowing. It is hoped that they eventually will disappear.

Personnel as Major Administrative Problem

The major problem presented in the administration of Section 722 is the matter of personnel. Section 722 presents a judgment question which touches upon at least three professional fields—law, accountancy, and economics—and on which there is wide difference of opinion even among members of the same profession. There are thousands of claims pending which require this extensive consideration. So we have the problem of developing the mass production of judgment answers on a sound and consistent basis. This resolves itself into the obtaining of personnel, training them, and organizing them. The organization problem is essentially the matter of determining the number and type of persons who will contribute to the final result. The answer to each claim is the product of several persons working simultaneously or successively. The volume of production depends upon the number and calibre of the persons available and upon the quality of work desired. We are not in favor of increasing production by decreasing the quality of the work.

The Council, originally, was composed of fifteen members. Now it is being expanded to twenty-five members and a corre-

sponding increase is being made in the staff. At the same time, final authority and responsibility has been shifted from the full membership to an executive committee of five members. This means that decisions on policy matters and debatable case determinations henceforth will be made by a five-man group rather than by a fifteen-man group—a change which should help to expedite decisions. The reorganization will not change the manner in which the Council members hold conferences and the procedure in so far as it directly concerns the taxpayers will continue without change, at least at this time.

The reorganization of the Council is being undertaken with the hope that the dispositions of claims will be expedited to such a degree that 90 per cent of the cases can be finished within three years. The final 10 per cent will present a special problem in any event and no reasonable estimate can be made of the time necessary to complete those cases. With respect to the 90 per cent, however, the organization and capacity of the Council is not the only factor which will determine whether these cases can be disposed of within three years. Equally important, although not frequently considered, is the capacity of the claimants and their representatives to complete their share of the undertaking within the three-year period. Can each practitioner complete one-third of his claims during each of the next three years? You are in a better position than we are to answer that question.

This three-year objective presents a difficult personnel problem for the Bureau, but we are in the process of meeting that problem. The other units of the Bureau have been extremely cooperative in helping the Council through the transfer or loan of valuable personnel.

Major Questions of Administrative Policy

The main program, however, presents more than a personnel problem. It presents also some major questions of policy. The questions which most directly concern practitioners include: How much conference time can we afford to give each claim-

ant? Should we permit additional information to be submitted after a conference has been held? Under what conditions, if any, should the Bureau prepare a reconstruction, and, if there is a Bureau reconstruction, should negotiations cease as soon as it is presented? In all of these matters we have been generous with our time in order that there may be no question but that each claimant has had full consideration. But the success of the three-year program may depend upon the adoption of a sterner attitude in the matter of the time allowed a claimant.

One of the major causes of delay in the disposition of cases is the lack of an adequate and proper explanation of the reconstruction which formed the basis of an agreement in a field office. It is the claimant's burden to provide a sound basis for a refund. And the claimant should be certain that the record contains a sound explanation of a determination agreed to in the field.

At this point it may be appropriate to say a few words about so-called "lump-sum" settlements. We require that each determination be supported by some mathematical or statistical explanation or some accounting reconciliation with actual experience of the claimant or its industry. We cannot accept a determination which says merely that, on the basis of all facts and circumstances, normal earnings is determined to be X amount. Such a procedure is not consistent with a sound administration. We have an administrative responsibility and, regardless of what the Tax Court may do in an individual case, we must have some means of knowing how a determination is arrived at, if we are to achieve any reasonable amount of uniformity in the application of Section 722. The Tax Court does not have responsibility for supervising the activities of revenue agents located in thirty-nine divisions throughout the country. The Court has one type of function and we have another. It is important that we do not confuse them.

There is a need for having a rather precise and reconcilable basis for a determination under Section 722. If a claimant is entitled to some relief, the amount of such relief is not to be

dealt with in general and vague terms. Its determination involves the application of both judgment and sound accounting and statistical methods. The result must be reasonable and also it must be arrived at by some sound method clearly explained.

In some instances, where the reconstructions submitted by claimants were unacceptable in amount or method, we have developed reconstructions. Sometimes these have provided relief and at other times they have not. In either event, we have endeavored to explain our determination to the claimant. This has been appreciated, I believe, but the three-year program may force us to reduce the time which we can spend in such explanations. We have spent considerable time in trying to convince claimants that our conclusions are proper in an effort to obtain a signed agreement from the taxpayer.

All these considerations seem to lead to the question of whether we may be forced to adopt some method of unilateral determination. By that, I mean, we should determine what we believe is a fair and just answer, use reasonable efforts to convince the claimant that our conclusions are fair and just, and then close the case on that basis, whether or not the claimant agrees with our determination.

This method would leave with the claimant the question of whether he should ask the Tax Court for a greater amount of relief. We do not like this method because there is a period of uncertainty after the case leaves the Council, but we may be forced to adopt it in order to prevent negotiations from being drawn out indefinitely. There is a serious doubt in my mind whether any organization, whatever its nature and size, can finish this task within three years without frequent use of unilateral determinations. In each case, the time will come when someone must have the courage to bring negotiations to a halt and say "this is the answer."

Ideally, it would be helpful to have a body of Tax Court decisions to guide us but it will take at least two years, and probably much longer, for the Tax Court to decide enough Section 722 cases for its opinions to provide any comprehensive

body of knowledge on the subject. In two years we are to have the task two-thirds completed. It is simply not in the picture for the Council to be guided by the pattern which the Tax Court may develop. If we are to finish in anything like three years, we cannot wait for Tax Court decisions but we must act without undue hesitation upon the basis of what we believe is a proper interpretation and application of the law.

PART FIVE

FEDERAL INCOME TAX ADMINISTRATION: PRACTITIONERS' ROUND TABLE ON ADMINISTRATIVE PROBLEMS

CHAPTER XVI

INTRODUCTION TO PRACTITIONERS' ROUND TABLE ON ADMINISTRATION OF FEDERAL INCOME TAXES

J. K. LASSER, C.P.A.

J. K. Lasser & Company

OUR SYSTEM of income taxation is rooted in voluntary compliance. That leaves a very large burden with both the taxpayer and the government. The responsibilities of the latter have more recently been officially emphasized.[1] Certainly the responsibilities involve creation of rules and forms [2] that will:

[1] This is emphasized in the report dated January 27, 1948 on the investigation of the Bureau of Internal Revenue by the Advisory group to the Joint Committee of the Congress appointed under Public Law 147: "Although primary emphasis seems usually to have been placed on the correction of errors that understate tax obligations, equitable administration requires that equal emphasis be placed on inaccuracies that overstate the taxpayer's liability. It is the function of the administrative agency to assist taxpayers in the determination of their correct tax liability. For those who are uninformed, or misinformed, the Bureau should serve both the interest of the taxpayer and the Government. The employment of tax specialists should not be essential to insure uniform, fair application of the law.

"The Bureau is not the Government's advocate; its responsibility is to provide uniformity in the application of the revenue laws irrespective of the immediate financial consideration. To no small degree the environment in which the Bureau appears an advocate has been created by the zeal of representatives of interests who can afford specialized attention to their tax problems. The vast majority of taxpayers, however, are without competent tax counsel and neither know nor can inform themselves of the unavoidable intricacies of the Revenue Code. For this large group the Bureau must scrupulously maintain a policy of equal regard to the interest of the Government and taxpayer. The same policy should apply in dealings with the clients of the tax bar and the tax accountants, although it is reasonable to assume that audit activity to ascertain overpayments of tax by the group will be sterile."

[2] On this the Advisory Committee Report (*op. cit.*) says: "In some respects simplicity has become a fetish which has imposed larger burdens on the Bureau than have been recognized in appropriations. This is particularly true of the

Avoid employment of specialists and yet fully insure uniform treatment for all taxpayers.

Help taxpayers generally to get the lowest tax the law allows them.

Correct quickly taxpayer inaccuracies.

Simplify every possible step.[3]

Form W-2 which absolves the taxpayer from any responsibility other than listing the names of his dependents, indicating his and his spouse's other income, and signing his name. An equally simple form and one which would be much simpler for the Bureau to process would require the taxpayer to respond to three or four questions relative to the nature of his income other than that on which tax has been withheld, and to give the necessary details respecting such other income. Just a few direct inquiries can save much costly backtracking in the Bureau and future annoyance to the taxpayer. It would also be a valuable aid to both Bureau and taxpayer if the taxpayer were required to compute his tax on the return.

"Other returns than Form W-2 exhibit similar defects. The whole series of forms dealing with excise taxes contain little information other than the amount of tax due and the name of the taxpayer or his agent. Such information is contained upon the remittance itself. The return does not provide a basis for any office audit or analysis and serves no purpose other than to add to the amount of paper work in the Bureau. If more comprehensive annual returns were substituted for the present quarterly and monthly returns on wage and excise taxes, the return itself could be made to afford the basis of an intelligent selection of cases for further investigation or field audit."

[3] On this the Advisory Committee Report (*op. cit.*) says: "In the personal income-tax field where taxpayers only once a year face the need for preparing a return, there are opportunities for simplification and a vastly expanded program of assistance. The instruction sheets which accompany the Form 1040, for example, although much improved from those of 1940 still are not easy reading and fail to present an objective picture of the taxpayer's rights as to deductions and expense allowances. It is admitttedly impractical for the Bureau to furnish a complete manual of instruction to each individual taxpayer but the present instruction sheet could be made far easier to use and less formidable, at an inconspicuous increase in over-all Bureau cost devoted to additional paper and printing.

"For the tax that applies to over 50,000,000 people there is a limit to the ability of the written word to insure proper compliance to the taxing statutes. Any improvement in forms, instructions, and supplementary documents, is thus of limited value. Closing this gap requires a vastly expanded program of personal service to taxpayers. By extending the filing limit over a period of 6 months, and making available the resources of technical personnel, the Bureau could in a relatively short time raise immeasurably the quality and completeness of original income-tax returns. No other utilization of personnel would be likely to produce as much progress toward the determination of correct tax liability.

"It is, of course, essential to the success of such a program that Bureau personnel be indoctrinated with an attitude of complete objectivity toward the taxpayers' obligations to the Government. They must, in effect, represent both the taxpayer and the Government, with the sole purpose in mind of obtaining a correct determination of the tax under the prevailing law and its current interpretation—the correct tax to which the Government is entitled, but not $1 more. A full-fledged and vastly expanded program of taxpayer assistance in preparation of returns would drastically reduce audit requirements and in the long run be productive of substantially increased revenue."

What Is Simplification

Simplification is a broad concept. It means so many different things to so many different people.[4]

For the great mass of taxpayers it means a return which is easy to fill out. Tax computations are often troublesome for people who are out of practice in arithmetic. Moreover, a multiplicity of income concepts, credits, and deductions makes for confusion.

For some people, the confusion is the accounting and record-keeping necessary before the return can be prepared. The Treasury has found that the mere recording and listing of deductions constituted the greatest complication for many, perhaps most, taxpayers.

For some, simplification means simpler language in the regulations and their underlying concepts.

Simplification to some people means the conditioning of the minds of

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[4] *See* speech by Roy Blough before the North Carolina Association of Certified Public Accountants in November, 1944. Randolph E. Paul (in a talk January, 1944) before the Rhode Island Institute on Taxation had this to say: "Some people would direct us back to statutory structure and its underlying concepts. A statute, of course, is always merely the beginning—a point of departure. In time, it is enriched by the live content of concrete factual patterns as administrative interpretations and judicial decisions add their commentary on legislative intention. It may be compared to a diminutive charter of government awaiting the impact of specific events. But beginnings are important, for while one does not end with the words of the statute, 'one certainly begins there.'

"Other people say the language of the statute should be less legal: We should abolish verbosity and make the statute as chaste as the Ten Commandments. This is easier to promise than to deliver.

"While I hold no brief for verbosity, it is safe to say that legislative reticence on a subject may often do more harm than good. A short 'simple' phrase in the statute may leave much confusion, misunderstanding and litigation, whereas a long, complicated section of the statute may accuractely and meticulously cover most of the cases apt to arise.

"The Socratic method would soon delevop a challenge to the simplicity of simple language: Is there such a thing as perfectly plain language? Some of our worst tax troubles have centered about the few uses in the statute of layman's language. You are all familiar with the famous insurance section of the estate tax statute, first enacted in 1919, which subjected to estate tax the proceeds of life insurance 'taken out by the decedent.' This provision consisted of merely five lines and undoubtedly the drafters thought they had done a fine job. But initial assumptions have long been overrun by a continuing flood of litigation as the courts and the Treasury Department have struggled valiantly with the seemingly crystal-clear phrase, 'taken out by the decedent.' In the 1942 Act Congress has wisely overhauled this provision, and while it is no longer confined to five lines, it succeeds in conveying its underlying message.

"If we pursued the Socratic line, the next question might be: What difference does the language of the statute and regulations make? Nobody reads it but tax lawyers and accountants. Fortunately they are still a small minority of our 50 million taxpayers, though as complications are piled like Pelion on Ossa, the tax lawyers and accountants may very well become bigger and better taxpayers."

enforcement people to a position in which they recognize they are not the government's advocates. They are the representatives of both the taxpayers and the government. That (argues the recent study of the Bureau of Internal Revenue by the Advisory Committee to the Joint Congressional Committee) is essential. It cannot be reversed by denials of the policy or elimination of its more glaring evidences of unofficial status. On the contrary, it can be changed only by a reorientation of the staff and revamping of procedures, forms, instructions, regulations, and all the rest of the taxpayer-relations job into another tone and atmosphere.

Finally, simplification has to do with eliminating the conflict of administrative bodies. We now make all sorts of unemployment insurance, social security, withholding, income tax, state tax, and other forms that could well be concentrated into one or two forms. Our administrative machinery operates separately for each tax. The result is often duplication and waste of manpower.

One of our problems in attaining simplification is the intrusion of accountants and lawyers. Randolph Paul long ago suggested he knew of no group as little qualified to pass upon questions of tax simplification as a group of tax lawyers and accountants. "True," he said, "they know taxes."

They are steeped in them. They have an enormous vested interest in that knowledge. They have progressed miles ahead of the many taxpayers who do not know the simplest things, such as how to add or subtract a blank item on the return. Most lawyers and accountants have lost touch with the homely thoughts of Joe Doaks who frowns over his record keeping, who cannot multiply by decimals, who finds mere words unbelievably tricky—which they are—and who would like a tax law which reads like a pill advertisement. To reduce tax rules and forms to the limits of Joe Doaks' mental processes is unreasonable, you say. It is reaching for the moon. That may be true. But Joe deserves every consideration, since he is the man who files and pays.

"Simplicity," said Paul, "is a part of fairness."

Regardless of whether we should have a government of laws or of men, laws are made for men. Men must live by them. They must understand them. For understanding is the first step toward orderly compliance. In paying taxes men and women are giving part of their time and energy to the Government. It is unfair for the Government to demand from them the extra time and energy required to master unnecessary complexities.[5]

[5] Speech before the Second Annual Institute on Federal Taxation in Providence, Rhode Island in January, 1944. At Chicago in October, 1943 Paul suggested that tax specialists were at fault: ". . . There are always taxpayers and

Complexity is sometimes defended on several grounds:

> Provisions must be necessarily complicated to prevent tax avoidance. "One dares not fire a shotgun into a crowd. They must be precise instruments which do their job of preventing avoidance without injuring innocent taxpayers. It is not enough to attain to a degree of precision which a person reading in good faith can understand:—it is necessary to attain if possible to a degree of precision which a person reading in bad faith cannot misunderstand." [6]
>
> Special reliefs properly cloud the picture. Page after page of the rules are devoted to particular cases.
>
> There is another important cause. Income tax law begins with [7] the statute, but it does not end there. It journeys on into interpretative regulations and administrative rulings. Then the courts make their retail contribution to a wholesale statute. To paraphrase former Chief Justice Hughes' remark about the Constitution: "We are under an income tax statute, but the statute is what the judges say it is."

A great deal has been done to simplify the tax mechanism for individuals, but little has been accomplished to cure inequities suffered by business under current laws.

One example is in the quantity of the rules. Now it takes a couple of hundred volumes of tax literature and a phenomenal memory to get anywhere near the process of treating many elements. Given a couple of more years of regulations and decisions, the abundance will be overwhelming.[8]

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tax specialists who are on the hunt for loopholes. Indeed, one court has said that tax avoidance is in the nature of mortals. I should be the last person to put blame upon anyone who attempts to minimize tax liability. The Supreme Court itself has hardly ever failed to render mandarin courtesy to the doctrine that 'When the law draws a line, a case is on one side of it or the other,' and if the case is on the safe side, it 'is none the worse legally that a party has availed himself to the full of what the law permits.' But I do insert in parenthesis that it is better at least for the uninitiated not to get too near the line, and I am sure that all of you will agree, particularly in time of war, to the necessity of insuring the end that 'no one should be permitted to avoid his just share of the tax burden.' The escaped burden is inevitably passed on to others."

[6] *Ibid.*

[7] *Ibid.*

[8] Professor Griswold states that the bulk of the income tax legislation "brings out in sharp relief the major defects in our income-tax structure. Reduced to simplest terms, these may be said to be complexity, uncertainty, and retroactivity. Much of the complexity is unfortunately unavoidable. A simple income-tax statute could probably be put together, but it would be full of injustices on the one hand, and gaping loopholes on the other. A large part of the expansion of detail and the complicated language in the statute is the result

Administrators must belong to the school urging that government has the real obligation to serve as a bridge to make clear the tax incomprehensible. Often the product is the direct opposite. That is easy to prove by reference to some simple sections of the Treasury regulations.

Lawyers and accountants labor with heavy pens when they write forms and regulations. That should be the job of experts who understand how to sell with basic English. The forms must be simple. For many it is the entire law, regulations, and all the decided cases. If that is so, assuredly we can assert a claim for help to the thousands of the well intentioned who struggle to find out what parts of them mean.

Part of the difficulty is the trend to reduce everything to words. Symbols and other short cuts from the science of mathematics would help much. Part is in repeated attempts to hedge and qualify. No one quarrels with that in difficult law. But it ought to be easy to state examples and the general rules in basic English.

Tax help for business often needs no wholesale revision of law. The Commissioner has wide enough powers to do most of a badly needed job. For example, it is he who designs an intricate embroilment used as a tax form by business, and who insists upon completion of each line in a lengthy arrangement. It is he who begins and ends a lot of other confusions that so disturb the little fellow. He tells him what detailed records he must keep, how to run his accounting system, what income is to be included, and what deductions he may take. And he can evoke heavy penalties for even comparatively minor infractions.

The absurd thing about federal taxes is that all businessmen are presumed to know the law. Yet not even the most learned experts presume to understand the complexities. And much of it is incomprehensible, even to the experts. The courts grapple

of attempts to allow for the many variations in the individual problems with which taxpayers are confronted. But it is undoubtedly true that a good deal could be done by a long and careful editorial examination and revision of the present statutes." (*Harvard Law Review,* LVI, 1356).

with it and judges differ among themselves. The result is often uncertainty and confusion. Planning ahead, so essential for business, with full knowledge of tax implications of transactions is often impossible. Yet everybody—including our small businessman—is presumed to know the law.

One fervent hope is that the Treasury will realize its problems and will do at least these things:

Get the best advertising man it can find to make all the rules and forms in simple, readable, pleasant, step-by-step style. The tax forms the small businessman has to fill out are just too much for him. They are too complicated and too lengthy. We have known some of them to require weeks of labor. The tax forms and instructions should be made as simple as A, B, C. They are *all* the law a small businessman can read. He should not be saddled with a cumbersome, Chinese puzzle type of tax report. Better yet, we might let the small businessman use his accountant's report, or the statements he gives his bank and credit grantors, as a tax return. Certainly the small taxpayer should not be compelled to fill out elaborate forms designed for the use of big business, or even read the voluminous instructions relating to the involved forms. It took considerable time and effort to get the Treasury to give us the present simplified system for the salaried taxpayer. All he does, in effect, is to sign his name to a small sheet. We can almost do the same, if we apply some common sense to the job for the benefit of the corner grocery store.

Show the tax forms around to a lot of us before they get into printing so that we can try them out on our friends and report reactions.

See what it can do to eliminate the present antagonism in business to all the complicated rules and forms. Perhaps the Treasury needs effective public relations methods with the American taxpayer—particularly at tax time. Certainly the Treasury has much to learn from Lux and Lucky Strike.

Other points require attention. We need to study these:

All of us now are required to file burdensome information—at source reports. Common sense ought to govern what we need—especially when noncompliance may bring down punishment for the little taxpayer. An example is the requirement that if $500 in fees is paid to a lawyer it must be reported. Failure to do so can land you in jail.

The small fellow's checkbook, the small retailer's cash register forms, or any primitive and homely records ought to be enough records to keep if they tell the true story, however crude. But the rules demand infinite detail—permanent accounts and records.

Problems with Uncertainties

One of our real difficulties is inability to get quickly advance Treasury statements concerning business plans and business commitments.[9] The result is unreasonable restraint on expansion. It would be a glorious feather in the cap of the Treasury if it could find some mechanisms by which business could do this—

> Write up its problem in simple, nontechnical fashion whenever the spirit or a transaction required a decision.
>
> Present it to sympathetic Treasury experts.
>
> Secure a binding agreement upon the business and the Treasury—so long as there had been a full statement of facts to the Treasury.

At this time, the process to get rulings and advance commitments is much too slow and much too technical. It ought to be converted to a basis in which the Treasury regards itself

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[9] ". . . After thirty years of the income tax, many very homely questions remain quite uncertain. If a businessman feels it is wise to yield to pressure from the OPA and pay over to them an excessive charge which they contend he made in a previous year, is the amount of the repayment deductible? And if it is, in which year must it be deducted? If past experience is any guide, we will probably learn the final answer to such questions in about seven years. Yet people have to act now. And with tax rates where they are now, the tax consequences of the act may be the most important matter in determining whether it should be done.

"Some of this uncertainty, like the complexity, is no doubt inevitable. But a good deal of it, one may think, comes from the decisions of the courts themselves. In the first place our present system of review in the Supreme Court by certiorari only after a conflict had developed in the lower courts postpones for too long the final determination of any disputed question. Tax cases are now so numerous and important that the time may well have come when we should have a single Court of Tax Appeal with final jurisdiction in all cases, except for review by the Supreme Court where constitutional questions are involved. Even under our present system, a good deal of the difficulty would seem to come because our courts have not surely found the line between judicial and legislative functions. . . . The revenue officers are hardly to be blamed for pushing each case to a decision. They can hardly tell where the lightning may be expected to strike. And here again we have the evil of retroactivity. Legislation by Congress is only mildly retroactive. But when the courts change the law, we preserve the polite fiction (based on the premise that the courts cannot change the law) that the law has always been as it is now declared. The result is in many cases at least five years of retroactivity. And another result may be found in a good deal of the complexity of the statute, which has had to be amended repeatedly to change the rules announced by the courts." (Griswold, *op. cit.*)

as an advisor to business and in its aid to permit it to move expeditiously in proposed changes.

A lot of help would come if we could get these steps:

> Get a better coordination with accounting groups before so many strange accounting rulings are issued. We need to stop rulings on matters inconsistent with recognized accounting principles. Perhaps a joint committee could be set up formed by the Bureau and tax men for discussion of tax accounting rulings before they are put into effect.
>
> Start up again a good Treasury Bulletin reporting rulings of all types so we eliminate the great secrecy and its inference of possible favoritism. We also need to publish all internal memos now issued on policy matters —instead of hiding them for only agent inspection.

Simplification of Accounting Practices

One of our enormous difficulties—greatly complicating our business tax reporting—is the willingness of the Bureau to permit such great distortion of tax accounting from accepted business practices.

The law provides a simple rule. The net income is generally to be computed in accordance with the method of accounting regularly employed in keeping the books. The following parts of the Regulations are typical:

> 1. If the method of accounting regularly employed by him (the taxpayer) in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for.
>
> 2. Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income.
>
> 3. It is recognized that no uniform method of accounting can be presented for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. He must, therefore, maintain such accounting records as will enable him to do so.

This seems extremely clear. It merely puts into words what accountants are always doing. The tax is found by determining income under generally accepted methods of keeping books.

But courts have gone astray in a great many directions—due entirely to interpretations by technicians who have never kept

books and who do not understand them. Here are some of our problems.

Income Received in Advance

Courts have held that income received in advance, even though there is involved a continued obligation to perform services and incur expenditures over a period of time in order to earn the income, is nevertheless taxed in year of receipt. That view is continued despite its abuse of generally accepted accounting principles, and the accounting methods consistently employed. These normally call for deferment of the reporting of that type of income until the period or periods in which it is earned by the rendering of the services and the incurring of related expenditures.

Our decisions have created all sorts of absurd tax results. They apparently hold subject to tax: advance payments or deposits (other than amounts received as loans); deposits received for safekeeping; amounts received as security for contract performance; and generally all advances

Even if there is no real net income for the year—in the accounting sense;

Even though their ultimate disposition remains to be determined;

Even if the amounts received may be refunded or transferred, or may eventually represent payment for services to be rendered in a later year, and the cost of which must be incurred or paid in a later year;

Even if the method actually anticipates income and under fluctuating business conditions materially and dangerously distorts the showing of annual income.

Warranties and Guarantees

Future costs for making good on warranties and guarantees cannot be deducted when you include the income. For example, a contractor must include his full contract receipts in income today, even though he remains responsible in later years for his guarantees upon his work. But cash settlements with a customer that eliminates the guaranty, give a deduction now. Ordinarily you cannot deduct estimated costs even if they are a very real liability.

Cash Discount on Sales

Cash discount on sales is not a deduction until the customer pays the bill. Discount accrued upon completion of a contract or on acceptance of shipment by a customer is denied. You get a deduction only when the customer settles. Good accounting practice would accrue the known cost.

Contested Expense Items

There is much confusion when expense items are contested. Accountants would insist earnings are properly stated only if deductions are made in the year in which the liability is created—even though it is not assessed or paid until some later year. But in tax accounting a deduction is often denied even if there is a real liability.

Moneys Paid in Dispute

You may often be taxed for receipts received under a claim of right when the moneys paid over are in dispute and you may be required to return them. In good accounting practice, we would hardly call that true income. Taxable income received under any claim of right is income to you when received, even if you may not be entitled to receive it, may have to restore it later, or take it under a dispute. The only exceptions to the rule seem to be these: your claim to the money is completely unwarranted; you are paid through a mistake; third persons set up a claim to take the funds from you.

Nondeductible Normal Reserves

Many normal reserves are not deductible. They include all sorts of deductions absolutely essential to establish profits.

Conditional Expenses

Many expenses dependent upon the actual receipt of a remittance from a customer are not deductions until the payment is received. A good example was the case of a company

in the business of publishing classified business telephone directories. It derived its income from sales, through agents, of advertising space. The commissions to be paid to the salesmen for procuring advertising contracts were not due until the amounts of the contracts were paid. The amounts due on the contracts were accrued as income. The court held these amounts were income, but that the salesmen's commissions on the unpaid accounts were not deductible. The theory was that the accounts for advertising were unconditionally due when the directories were published. But the amounts due salesmen for commissions were contingent upon the customers paying their accounts, and there might be a distortion of taxable income if the accounts were not later collected. That is wholly foreign to good accounting practice.

What Simplification Can We Give the Smaller Taxpayer

A good deal of taxpayer aid is possible in forms, instructions, and regulations. Much, too, can be said for Treasury fair dealing with expenses incident to the earnings of personal incomes. We now freely allow business deductions for costs of securing income, but find all sorts of chances to deny the same basis to the individuals.

Some twenty-five years of tax administration have built up a host of decisions that fail to recognize the ordinary, necessary expenses of earning individual incomes. We need recognition of unjustifiable discriminations against one citizen in favor of another—discriminations often in favor of business against anyone who chances to earn a livelihood elsewhere. Let me put down a few obvious inequities. As I do so, keep thinking of the individual who, merely by the fortune of his particular type of employment, his environment, or the particular social consciousness of his employer, has few of these costs to meet. Then see if you can reason whether simplicity in statute or difficulties in administration are worth the present shortcomings.

Uniforms and the cost of maintaining them should be a deduction when they are part of the requirements of a job. Contrast these costs with the fortunate group who wear their street clothes to work and to the theatre.

Cost of transportation to and from work should be a deduction. With today's living difficulties, the choice of where one shall live is not the province of the employee. He takes what he can get, even if it is twenty miles away from his work.

Cost of traveling in search of employment and moving expenses when a place of employment is changed seems like ordinary expenses of earning an income. We allow them to a business, but never to the individual.

Cost of freeing oneself from domestic duties to earn a living should be allowed. Think of the cases of the wife supporting herself on a meager income when the husband is gone. If he were about, the family unit would have a wage earner and also one equipped to manage the children and the home.

Educational costs are fair charges to income. Think particularly of the burden taken on by many in self-defense as well as those required to maintain studies to hold their jobs.

Political contributions by civil service employees and others where the measure of coercion is present reduces income. If the system is against public policy we certainly have not been very kind to the coerced contributor.

A great many others can be listed.

Nuisance Assessments

One of the real problems is a policy of obtaining the greatest possible revenue *for the year under consideration* without regard to tax consequences in other years. Lots of our problems concern items denied as a deduction this year but allowed in a subsequent year. The result is endless difficulties to find: what depreciation rates to use; whether the government or taxpayers are inconsistent; what is a capitalizable and noncapitalizable expense; adjustments in prorating nonbusiness expense; insurance premiums; lease expense; small repairs; bond premiums; etc.

The amount of tax involved in these adjustments is generally small, but the difficulties they cause in taxpayer reception is enormous. Government examinations might well omit changes unless they are significant and will not correct themselves in later years.

CHAPTER XVII

POST REVIEW PRACTICE RELATING TO AGREEMENTS

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SPECIFICALLY, I urge a change in Post Review practice relating to agreements reached with the office of the internal revenue agent in charge after protests have been filed by the taxpayer.

Briefly, every case resulting in a proposed tax deficiency goes through the following preliminary steps:

1. The field examiner's findings are reviewed by agent reviewers.
2. After the protest is filed, the findings of the Bureau conferee are reviewed by conferee reviewers.

Thus the case has been scrutinized and reviewed by several competent individuals in the Bureau before it is ultimately forwarded to Washington. The last step is a review of the case by the Audit Review Section of the Income Tax Unit in Washington. Should the Review Section determine that the settlement reached in the field was not proper, the Section returns the case to the field with instructions to revise the original conclusions consistent with the determination by the Review Section.

A Post Review of field cases serves two functions:

1. It determines whether the case was closed on a correct basis in light of its particular facts.
2. It aids in coordinating and bringing about consistency by determining whether or not the action taken was consistent with the policy of the Bureau in similar cases throughout the thirty-nine field offices.

Admittedly, this function of Post Review is desirable and should be continued. However, it is urged that the function of the office of Post Review should be limited to the purposes above expressed. More specifically, Post Review should not be permitted to reverse or otherwise change a settlement reached between the taxpayer and the office of the internal revenue agent in charge. Its function should be consistent with that of the Post Review Section of the technical staff. The Post Review Section of the technical staff may disapprove a case and suggest that the same decision not be made for future years. For the particular tax year, however, the staff field settlement is sustained. This practice has worked very satisfactorily.

The number of cases which Post Review turns back to the conferee or the agent in charge is relatively small. Furthermore, by reason of the recent change in the procedure whereby a Post Review reversal requires a field conference with a Washington official (if the taxpayer desires), the number of Post Review reversals ultimately sustained is even smaller. All cases are competently reviewed in the local offices, and the Bureau has had sufficient decentralization experience to do away with Post Review reversals. There is no chance of a raid on the Treasury should the urged change be made since conferees are traditionally inclined not to be overgenerous. Again, any settlement made by a revenue agent or conferee is now subject to review in the local office and safeguards can be imposed upon overenthusiastic settlements.

It is submitted that the change in practice here urged would be real and full decentralization. The Washington office would then be in the position of a rule-making and coordinating agency and be taken out of its present position of deciding specific cases at long distance without a full knowledge of the flavor and atmosphere of the case.

Under present procedure a taxpayer may not be notified of a change by Post Review for many months or even years after settlement had been reached in the field. The taxpaying public has a full right to an expeditious determination of its tax

liability. The delay occasioned by the present practice generates ill will rather than a required good will relationship between the taxpayer and his government. In order to instill confidence in taxpayers that their agreements with the field may be final, and in order to give freedom of action to conferees in the settlement of cases, reversal by Post Review in Washington must be abolished.

For the foregoing reasons it is urged that the present Post Review practice be changed to the end that all administrative settlements reached as a result of negotiations with the office of the internal revenue agent in charge be accorded the same administrative finality as settlements reached with the technical staff.

CHAPTER XVIII

PETTY OR NUISANCE ADJUSTMENTS

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PETTY ADJUSTMENTS and nuisance adjustments to my mind fall into different classifications and I shall, therefore, discuss them separately.

I shall define "petty adjustments" as those made by revenue agents which involve only a couple of hundred dollars in amount; they are not of sufficient importance to warrant protest and the taxpayer will usually reluctantly agree to them. These adjustments would include such items as minor depreciation changes and capitalization of sundry border-line repair items, involving comparatively small amounts. The agent reduces the depreciation rate or capitalizes the repair items and then the taxpayer is faced with similar adjustments, or the filing of claims for refund, for the intervening years between the taxable year and the year when the adjustments are made. It is almost unbelievable the number of times tax practitioners run into these small and vexing changes, where the over-all effect on taxable income, over a period of three years or so, is *nil*.

My suggestion for remedying this situation is that an inter-office communication be addressed to all field agents and the office audit staff to the effect that where these adjustments are negligible and merely transfer an item from one year to one, two, or three subsequent years, such adjustments should be disregarded.

Another type of petty adjustment involves disallowing sundry cash expenditures by individuals, such as contributions. An in-

dividual who has been quite generous and frequent in his contributions to a large number of organizations will normally have quite a number of cash contributions; for instance, to the March of Dimes, the Volunteers of America, the Red Cross, the Salvation Army, etc. I have seen agents arbitrarily disallow 50 per cent of such contributions for lack of substantiation.

In this connection, I suggest that as a remedy a memorandum be addressed to all agents setting forth a principle based on the George M. Cohan decision of many years ago. Under that decision, as you will remember, the taxpayer was allowed deductions, even though he couldn't substantiate them; he didn't have receipted bills or canceled checks. The court held that it was obvious that he had expenses and an allowance should be made despite the fact that they could not be fully substantiated.

We have all experienced revenue agents' proposals to make the above types of adjustments many times and we've tried to dissuade them but very often without success. I must hasten to add, however, that this is not the general rule. The older men, that is, older in point of service, and the more intelligent and capable younger men are more likely to look at such possible adjustments from a more practical point of view. You run into these annoyances mostly in your meetings with the "eager beaver" type of younger revenue agents who seem to think that they must show an additional assessment on each and every return examined.

Now, we come to "nuisance adjustments." These adjustments would include the disallowances of deductions, or additions to income, where the amount involved is substantial and the agent is reluctant to take the responsibility of deciding as to the propriety of the items. He wants to "pass the buck" to the conference committee or the technical staff. I've run into several of these in recent months. On two occasions, at least, within a matter of the last three or four months, an agent has left my office quite convinced that an item was proper, but suggesting that he would like to discuss it with someone at his office, either his group chief, or a conference committee

member. The next thing I heard in the matter was the receipt from the agent of a request for a signed Form 870 agreeing to an additional tax based on the adverse adjustment.

On a number of occasions, I have gone down to the conference committee and the item in question was allowed without any serious trouble. The agent was just afraid of the amount.

I would suggest as a remedy to this that a communication be addressed to agents instructing them that where there is a questionable item it should be reduced to terms of, say, a hundred dollars. In other words, the amount involved shouldn't have the slightest bearing on the propriety of the treatment, and it should be impressed on the agent that the principles of taxation are not different for different amounts involved.

I further suggest that where there is no agreement between the taxpayer and the revenue agent on any questionable item, it should be mandatory that, then and there, while the examination of the return is still under way, a conference be arranged with someone, preferably an experienced conferee, specifically assigned to deal with such disagreements and given authority to settle them.

Taxpayers can now, of course, request an informal conference on a controversial issue, but this is not standard procedure, and such conferences very often do not achieve the desired result of settling the matter satisfactorily.

The usual procedure, of course, is that the revenue agent issues his report proposing adjustment of the questionable items, the taxpayer protests, and many, many months later a conference is arranged. The chief objection to this procedure is that the revenue agent is seldom present at the conference—very often he has, in the meantime, been transferred to another district, or is then on sick leave, or on a special assignment out of town, or the like. The conferee is therefore forced to rely on the agent's notes and work-papers. The taxpayer is then required to refute the agent's findings, even to the extent of inadvertent errors in his notes or work-papers, in a manner or form convincing to the conferee.

If both the agent and the taxpayer could sit down with a specially assigned, top-flight conferee while all the facts and arguments were fresh in their minds, and thrash out the controversy, a great deal of time and money would be saved the taxpayer and his government.

CHAPTER XIX

PROCEDURE FOR PAYING AN ALLOWED REFUND CLAIM

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THE BUREAU of Internal Revenue is a large and in many respects a sprawling organization of government. It is inevitable that the administration of internal revenue laws shows from time to time an imperfect coordination in some Bureau activities.

Many complaints leveled against the Bureau for alleged arbitrary and highhanded acts and inconsistent positions with respect to taxpayers similarly situated, are, in my opinion, of relatively small significance, when viewed in the light of the over-all job done. To the extent, therefore, that any of the complaints made in this session, are, or may be deemed to be, of that character, I hereby give notice—for whatever it's worth—that I disassociate myself therefrom, notwithstanding my appearance in this panel of eminent, distinguished complainants.

One would have to be oblivious to facts, however, if he did not admit that there are procedural routines in the Bureau which require overhauling, complete modernization, and effective streamlining. One of them relates to the handling of claims for refund of tax.

I refer to procedure for paying an allowed refund claim. Consequently, nothing said herein involves the allowance itself of the refund claim, also a subject which needs re-examination. Except in the case of refunds of withheld income tax on the so-called short form returns, basically, the present procedure

for handling a refund claim which has been allowed was established at a time when the number of taxpayers was considerably smaller and the amount of collections nowhere near what it is today. Notwithstanding the tremendous strides made in the number of taxpayers and the amount of collections, there has been little fundamental modernization in the routine set up years ago for allowance of claims.

For example, out of the whole welter of examples, the schedules of overassessments prepared in Washington may contain refunds to as many as two dozen different taxpayers on each schedule. If, for some reason, the collector to whom a schedule is sent for rechecking has any question with respect to any one refund on that schedule, all other refunds on that schedule are held up until the trouble is discovered and, if possible, eradicated.

Although some form of schedule of overassessments appears to be necessary, it would seem possible to work out a routine which would allow each refund to be handled individually and independently of refunds which are wholly unrelated and in no wise connected with the refund in question.

Careful examination of the Bureau procedure has also indicated, among other things, that a refund claim, other than a refund claim based on a short form return, must make at least two full round trips between the local collector's office and Washington before any refund check is issued to the taxpayer, who, by hypothesis, is already entitled to the check.

It would seem that here, too, streamlining would result in considerable time-saving and substantially less wear and tear on the nerves of taxpayers who are entitled to refunds and, I should add, of their lawyers whose fees depend on the receipt of those refund checks!

There are a not insubstantial number of taxpayers who, because of the sheer ponderous refund procedures, are required to wait inordinate lengths of time for refund checks on refunds already allowed. I am certain some of you have already had that experience.

Except in unusual situations, such should not have to be the case. The Bureau is, I believe, fully aware of the need for streamlining its refund procedures in many respects not here covered. Its attention has been called to the subject by the Section of Taxation of the American Bar Association, through a report presented in 1948 by James K. Polk, then Chairman of the Committee on the Bureau of Internal Revenue Procedure.

All those interested in establishing modernized procedures, which in no wise open the door to unwarranted refunds, should join in appropriate efforts to have such procedures adopted. Modernization would undoubtedly result in substantial savings of interest paid out by the government on unnecessarily delayed payments of refund checks after allowance of refund claims.

CHAPTER XX

SECRET RULINGS AND DECISIONS

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THE TAXPAYER often finds that decisions in his case are made on the basis of instructions, rulings, or opinions which the taxpayer is not permitted to see. He may not even be advised of the basis and reasoning which leads to a conclusion which a revenue agent, conferee, or other Bureau employee may apply.

The taxpayer may cite the "Cautionary Notice" in the Internal Revenue Bulletins, which states: "No unpublished ruling or decision will be cited or relied upon by any officer or employee of the Bureau of Internal Revenue as a precedent in the disposition of other cases."

Bureau employees may answer that, whatever this means as to others, they have these memoranda, instructions, opinions, and decisions which are binding upon them, which they cannot cite or reveal or even discuss. They may even tell you this is the only possible way the work of the Bureau can be conducted under laws and regulations as involved, complicated, difficult, and uncertain as those we have, with the continual stream of rulings and decisions which Bureau employees can hardly hope to keep track of—much less know which ones the Commissioner is willing or is not willing to have followed.

I am inclined to agree that under such laws as we have Bureau employees probably must be guided to some considerable extent by instructions given them by their superiors, but

if this is done, there should be a willingness to disclose to the taxpayer any instructions, memoranda, rulings, or decisions which are the basis of any position taken by an examiner, conferee, or other employee with respect to the taxpayer's affairs. If those are in error, or are being erroneously applied, the taxpayer should be given opportunity to point out such error and have it corrected. This I think is the only way to do justice to the taxpayer and to get a correct body of procedure within the Bureau.

Of course, the Bureau cannot disclose the affairs of one taxpayer to another, but if a decision in one case is applied to another a proper abstract or summary showing the basis of the decision could be prepared and delivered to any taxpayer to whose case it was considered applicable.

Another point in this connection is that the taxpayer may find the decision in his case is made by some reviewer or other person, usually undisclosed, before whom the taxpayer never has opportunity to appear for argument or submission of evidence. It is right that an examiner's proposed findings should receive adequate independent review. It is wrong, however, that decision in the taxpayer's case should be made by one before whom the taxpayer has no right to be heard.

It is true that a taxpayer always has his further right within the Bureau or in the courts to contest any Bureau determination by which he feels aggrieved, but protest or appeal is more difficult if the taxpayer does not know the basis for the Bureau decision.

If our income tax is to be successful, taxpayers must feel the Bureau intends to deal fairly with them. They can hardly have this feeling if Bureau action is based on secret instructions or rulings it is unwilling to disclose, or if decisions are made by those before whom the taxpayer is not permitted to appear.

I believe the Commissioner and the Bureau in general have striven earnestly to promote courtesy and fair dealing with taxpayers and they want to have and to merit the confidence of taxpayers in the government. I think they simply have not

appreciated the extent to which this matter of secrecy of memoranda, instructions, and opinion and decisions exists within the Bureau, and its effect on the feeling of taxpayers towards the Bureau and its administration.

CHAPTER XXI

JOINT CONSIDERATION OF SECTION 722 RELIEF AND STANDARD ISSUES

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THE DIFFICULTY with the Bureau which I will discuss is the Bureau's unwillingness to consider both Section 722 relief and so-called standard issues at the same time in a case involving a deficiency in excess profits tax. In the case I have in mind, a deficiency was proposed in excess profits tax. The corporation filed a protest to the proposed deficiency, setting up as defenses both a claim for relief under Section 722 and also a claim for an increase in average base period income by reason of abnormal deductions. At that time the statute permitted a taxpayer to seek relief under Section 722 in opposition to a proposed deficiency. Thereafter the statute was changed, so that relief under Section 722 could be claimed only by way of refund claim after payment of the tax. Nevertheless, the Bureau was willing as a matter of practice to consider Section 722 claims in the deficiency stage, but the Bureau would do so only if the taxpayer abandoned the so-called standard issues, that is, all the issues other than the 722 issue.

In the case I have in mind, the taxpayer had a pretty good claim for disallowance of abnormal deductions, but it had an even better 722 case. In the then unsettled state of the law, with new decisions constantly coming out both on abnormal deductions and 722 relief, it was difficult to make a decision to abandon what might be a good case for disallowance of abnormal deduction under Section 711(b)(1)(J) and advise the

taxpayer to rest exclusively on Section 722. The Section 722 case was not so good as to warrant a lawyer to advise the client to abandon the standard issues. If the taxpayer made the decision to abandon 711 and stand on 722, it might find that later cases improved its claim for abnormal deductions and weakened its claim for 722 relief. The taxpayer's request to have the two issues handled together was denied by the Bureau. The result was that the taxpayer went to conference on the abnormal deduction issue and took a fair settlement on that issue, but was required in making the settlement to agree to withdraw the 722 claim. This meant that the taxpayer never had an opportunity fully to explore its whole case, but was under pressure to accept a settlement on one issue without consideration of another substantial possibility of relief.

The remedy for this situation is obvious and simple. There is no reason why the conferee cannot consider both 722 and standard issues in a deficiency case, and if, by reason of the division of responsibilities in the Bureau as between 722 issues and other issues, two different individuals in the Bureau are handling these two aspects of the case, there is no reason why they cannot participate in a joint conference. At least in one other case, which involved a refund rather than a deficiency, the Bureau was willing to arrange a joint conference involving the standard and 722 issues with a resultant satisfactory settlement on both issues.

In the same case I have been discussing, the taxpayer had its head office in state X when the return was filed, but moved its head office to New York afterwards. The taxpayer's attorney also had his office in New York. The taxpayer requested the Bureau to refer the case to New York for conference, but the Bureau was unwilling to change the place of conference from state X to New York. The Bureau gave no reason for this unwillingness except to say that it was the practice not to make such shifts.

There seems to be no good reason for this unwillingness. While it is true that, if the agent who made the examination

were to be present at the conference, the Bureau would obviously prefer to have the conference at the point where the agent was located, the conference in question actually took place in a city other than the one in which the agent was located, and the agent was not present at the conference. From this point of view the conference might just as well have been held in New York. If it then developed that additional investigation had to be made by the office of the internal revenue agent, that could either be done by a New York agent (since the taxpayer's head office now was in New York) or could be referred back to the agent who had handled it in the first instance.

CHAPTER XXII

WAIVER FORM 872

W. Godfrey

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IN SOME RESPECTS, it may be fair to say that Section 275 is the most important section of Chapter One of the Code to the Commissioner of Internal Revenue. Up to that point the Code has been busy setting forth in tremendous detail who is taxable, how the tax should be computed, and at what rates. It has been dealing with the question up to that point chiefly on a self-assessment basis, but when we get to Section 275, we find those stark words: "the amount of income taxes imposed by this chapter shall be assessed. . . ." This, of course, relates to the assessment of the difference between the amount which the taxpayer has assessed himself and the amount that the Commissioner believes to be correct.

The Section goes on to use some words which are of extreme importance to the taxpayer. Those words are: ". . . within three years after the return was filed." Those words should constitute, one would think, a kind of iron curtain; but the Commissioner has a handy device which makes the iron curtain a good deal less effective, perhaps, than a lace curtain. That device is the waiver—Form 872.

The legislative history of Section 276(b), under which the form is issued, doesn't throw much light on the type of case or the circumstances or the conditions under which it was contemplated the form would be used. One thing is clear: the words of the statute call for a consent by both the Commissioner and the taxpayer, and that consent is to be in writing.

It is easy to see why the taxpayer might wish to defer assessment, but it is more difficult to see why the Commissioner should agree, as he has not only the right but also the duty to assess. His consent would appear to be an act of grace, probably intended to preserve for the taxpayer such mechanics as a right of appeal to the Tax Court. As the statute of limitations is so vital a protection for the taxpayer, it would seem that he should consent if, and only if, he has some very good reason to delay assessment.

One reason, of course, might be to avail himself of admintrative procedures before exposing himself to legal procedures. The waiver provision was probably intended to be used in those cases where the Commissioner says, in effect: "The bell is about to ring. There are some matters on which we can probably get together. Let's try and get together on an administrative basis before we get tangled up with the law."

In that case, of course, consent involves no duress. In any event, the taxpayer can always say: "Go ahead and assess. I know what problems are involved and I'll take my chances with the courts." But that is true in only those cases where the examination has been completed.

What is the position of a taxpayer who is invited by the Commissioner's representative to consent to an extension of the statute when the points at issue have not been defined and when in fact no examination has been made at all, or an incomplete examination has been made? This, to my knowledge, is done as standard practice in several areas.

Of course, the taxpayer can refuse to consent, but he usually signs on the dotted line and extends the statute by fifteen months. When it is used in that fashion, I think, the form constitutes an artificial device for extending the statute. In effect, the Bureau rewords Section 275 and makes it read: "The income taxes imposed by this chapter shall be assessed within three years of the filing of the return, or at such other time as the Commissioner gets around to it."

I have discussed this question of the improper use of waivers

in Washington, and I have been advised—I think quite sincerely—that the use of waivers to enable a revenue agent or the revenue agents in charge to catch up on their schedule has no official sanction. The official view is unfortunately far removed from the field, however, and it is the revenue agent and not the Commissioner who walks around with his pockets stuffed with 872's.

It seems idle to talk of the taxpayer's right to consent or not consent as he pleases. I've known of hesitant taxpayers who have been threatened with jeopardy assessments. To my knowledge, the threat has never been carried out, probably because the threat in itself was enough.

What is the cure for this situation? It seems to me that as the evil is an administrative one, the cure is probably an administrative one, too. I think the Bureau should bar the use of Form 872 in all cases where the examination is incomplete. It may sound as though the cure is worse than the disease and that there will be a shift from the consent waiver to the ninety-day letter or to the use of Form 870, but in those cases the taxpayer has no legitimate complaint; they are the outcome of an examination.

This discussion has been based on the assumption that the improper use of Form 872 is the result of the revenue agent in charge being behind schedule, and that again is an administrative problem. It would seem that the efficiency of the Bureau would be improved by insisting that the work in the field should be completed within the time laid down by law. There is no justification for extending that time by obtaining a consent which results in the taxpayer's exercise of a "Hobson's choice."

CHAPTER XXIII

PENSION AND PROFIT-SHARING PLANS

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FIRST, I want to say that a little perspective is helpful when we stop to think that the total number of plans in this country before World War II was only about one thousand, after some seventy-five years of history on that subject in the United States.

During the few war years, we added approximately eight thousand new plans, so that there are probably few fields of taxation where the Bureau has had thrust upon it so suddenly so much new work to do. All of us, having lived through that period, know what a magnificent job was done in getting out from under that terrific load.

The second point to remember is that this is a technical subject, in which Congress laid down certain principles, but then left so much to the discretion of the Commissioner because there wasn't time to consider properly all technicalities in the 1942 hearings, prior to the passage of the Act. That was all that Congress could do. Nevertheless, it meant that instead of a lot of things being clearly thought out in the law, the Commissioner had to make up his mind on a lot of these things.

As a result the policy of decentralization was worked out. This was the only way to solve that mass of accumulated work, and considering everything, in my judgment it has been done magnificently.

As a result of decentralization, however, certain special problems have developed. Some are perhaps unique to the pension field. Others apply to other forms of taxation as well.

Now, what are some of the problems? The first one is perfectly obvious, and that is, that we don't get uniformity of administration. That's one of the prices we pay for some of the advantages of decentralization. Now, let's be practical. What can we do to get the advantages of decentralization, and overcome the important disadvantage of nonuniformity that exists in some areas?

By and large, we find fine administration in a great many spots in the United States, but we don't find equally fine administration and equally uniform administration throughout the United States.

Well, as matters stand now, if you go before one of the local revenue agents, or to a bigger area where they have to have a conferee set up in this field, and you don't see eye to eye with his point of view, where do you go from there? You don't have that same easy flow that you get in other fields of taxation. My suggestion is that there should be created that easy flow, so that the taxpayer can automatically ask for a conference.

I suppose the conference would be with a representative of the Pension Trust Division from Washington. It seems to me that it would be better if the Pension Trust Division had traveling men going all over the United States to the taxpayers rather than having all the taxpayers run to the Pension Trust Division in Washington.

It might be done both ways, however, depending on all the facts and circumstances. But in any case, the taxpayer ought to be able to ask for, and get, his formal conference with someone who is closer, perhaps, to broad policy on some questions in which there has been a natural difference of opinion, because we have another unique thing here in this tax law. It's social legislation mainly when you talk about Section 165 of the Code. But it's dollars and cents when you talk about 23-P, so that you get a lot of mixed confusing ideas. When the taxpayer is seeking approval under Section 165, which is all that you get a ruling on from the revenue agent, some revenue agents feel very strongly on the question of vested rights, and

some feel very strongly on the question of maximum ceiling while other agents feel very strongly on the question of partial termination. And so on. The agents generally are able, conscientious men doing their duty as they see it, but there are honest differences of opinion, as to the intent of Congress, and we know that those differences of opinion of the field agents are quite different from the opinions held by the Washington Pension Trust Division in some cases.

In other words, there is not uniformity of treatment, and the concrete way to help get it is to get that easier automatic flow of conferences. Now, this question of lack of uniformity of administration due to unpublished rulings also has its impact in this pension trust field, because the taxpayer doesn't know the basis of the revenue agent's decision, and hence is unable to clear up differences between the agent's point of view and that of Washington's Pension Trust Division with reference to those unpublished rulings.

The next question arising out of decentralization is the speed of rulings. Some sections of the country are more abreast of their regular work than others, and my suggestion is that the Bureau require of the revenue agent that he give his opinion to the taxpayer, good, bad, or indifferent, within a specific time from the time he gets the application for the ruling on the case.

Let's say sixty days. In other words, if the taxpayer makes application under a new plan, or under an amendment of an existing plan, or for total termination, or partial termination, then he would get his answer back from the local revenue agent in sixty days and get a conference with the local revenue agent inside of thirty days thereafter, if the ruling is adverse.

Now, that may mean that at certain times, being highly seasonal, the Commissioner may have to allocate more men to this work. Unfortunately, it's not a revenue producing job under 165. It's a revenue saving job under 23-P as to claiming too much of a deduction, but nevertheless, there it is. We have

the tax law, and as long as we have it, we want to administer it properly and we have that problem.

The matter of timing is very important when you're dealing with anything that has a deadline. Let's take an example of a new case. Say, a company is on a calendar year basis. Now, of course, they ought to make application for a ruling, we understand, on January 1, 1949, for a plan that's going to go into effect, say the following December 31 of 1949, in order to have plenty of time for a ruling. But being businessmen, we know that taxpayers do not do this.

Unfortunately they wait until well on into their tax year. Hence, say that the taxpayer does not submit his application for ruling until October 1 and copies go to Washington, then get back to the field maybe on October 10. Then the field man has twenty, thirty, forty, or fifty cases ahead. Worse than this, I have had one revenue agent tell me that his deal with his local agent in charge permitted him to work on pensions at home in the evenings, and on Saturdays and Sundays, because he did not want to lose his contact with regular tax work during the week. That is his point of view.

But look what it does to the taxpayer. You come up against a point which, in effect, violates the intent of Congress as stated in the law. Congress said we could have seventy-five days from the end of the tax year in which to make any amendment of any case and still get credit for the previous tax year.

So in other words, on a December 31 tax case, we would have until March 15 of the following year. Well, if we don't get a ruling by December 31 from the local revenue agent, and we don't get it until the January or February or even close to March 15, the taxpayer is under duress. He is on the spot. He's got to take any of the pet ideas of this local revenue agent whether he likes them or not—or else forfeit his ruling within the seventy-five days.

The result is that there are some revenue agents throughout the country who think they are right on certain points because so many taxpayers have conceded to their view. They do not

realize that the reason that many taxpayers have conceded to their point of view is that they had a time problem. They were up against it. It was a take-it-or-leave-it proposition, and no taxpayer wants his deadline of seventy-five days after the end of the tax year to go by on a new case without some sort of an approval. So he'll pay the price and he will give in on something that he knows very well he could get through Washington on regular uniform administration—if he had time to appeal it.

CHAPTER XXIV

THE TAXPAYER'S DILEMMA IN REFUND CASES

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THE INGENUITY of tax counsel in the handling of family partnership cases, until recently chafing under, and shackled by, the combined and painful impact of the Supreme Court decisions in *Commissioner* v. *Tower*,[1] *Lusthaus* v. *Commissioner*,[2] and *Dobson* v. *Commissioner*,[3] finally found itself somewhat liberated by a dual circumstance.

One was the passage by Congress of Public Law 773 (H.R. 3214), signed by the President on June 25, 1948, which provides that Tax Court decisions shall be reviewable upon appeal to the same extent as similar decisions of the District Courts of the United States, in effect repealing the *Dobson* rule.[4]

The other circumstance was the decision of tax counsel to avoid the Tax Court and to resort, wherever possible, to the technique of having the taxpayer: (1) pay the deficiency, (2) file a claim for refund, and finally, (3) institute suit in the United States District Court for the amount claimed. The basic advantages in pursuing the latter procedure were considered to be the stopping of interest upon payment of the deficiency, the earning of interest upon any amounts ultimately refunded, and the availability of a trial by a jury consisting of the taxpayer's peers, wherever a jury trial was desired and demanded. The last element has, in many quarters, been considered the

[1] 327 U.S. 280 (1946).
[2] 327 U.S. 293 (1946).
[3] 320 U.S. 489 (1943).
[4] See I.R.C., §1141(a).

most important, it being thought a *sine qua non* to victory in a doubtful case that a family partnership be judged by twelve men and women, some of whom may have a problem of their own akin to that presented to them for decision. And it is a well-known fact that taxpayer victories in these family partnership cases have been on the upgrade since trial by jury in such cases has come into full bloom.[5]

There are, however, some administrative difficulties which may, if not eliminated, cause vexation to taxpayers, eventuate in cross actions between taxpayer and the government, and result in much waste of time and money. These can best be illustrated by a typical situation.

Typical Situation

Let us take the typical family partnership case, involving a father, mother, and two children, each of whom has a 25 per cent interest in the partnership, according to a written agreement of partnership. The Commissioner of Internal Revenue decides not to recognize the partnership, and proposes to include in the gross income of the father all the income reported on the partnership information return as having been distributable to the other partners. The Commissioner accordingly asserts deficiencies in income tax against the father in the assumed total amount of $60,000 for the taxable years involved; he proposes overassessments with respect to each of the alleged partners in the respective amount of $10,000, or a total proposed overassessment of $30,000. Upon advice of counsel, the taxpayer decides to pay the deficiency and eventually prosecute his claim in the United States District Court.

In due course, the mother and children receive a notice on Form 493 M, consent to credit, which advises them that the income for the years in question originally taxed to them is apparently taxable to their husband and father, respectively,

[5] *Mallary* v. *Allen,* ¶72,615 P-H F. 1947 (D.C. Ga., 1947); *Knott* v. *Allen,* F. Supp. ¶72, 414 P-H F. 1947 (D.C. Ga., 1947), *aff'd,* 166 F. (2d) 798 (C.C.A. 5th, 1948); *Hager* v. *Kavanagh,* ¶72,462 P-H F. 1948 (D.C. Mich., 1947); *Riggs* v. *Thompson,* ¶72,587 P-H F. 1948 (D.C. Ark., 1948).

and which seeks to authorize the credit of their apparent overpayments in tax to the proposed deficiency in question.

In order to expedite the matter and to assuage the sting incident to the payment of an asserted deficiency of $60,000, the consents to credit are executed by the family members and transmitted to the Commissioner. Thereafter, the signatories receive, on Form 7776, certificates of overassessment from the Commissioner of Internal Revenue advising each one that the taxes assessed for the taxable years involved exceed the amount of taxes due from each by the amount of $10,000, and that the entire amount of the overassessments has been credited to the tax deficiency of the family member. The effect of this, obviously, is that the credit of $30,000 reduces the amount payable from $60,000 to $30,000. Subsequently, the taxpayers with respect to whom the overassessments were found receive, on Form 7782, from the Commissioner of Internal Revenue notice of interest allowances on the credits referred to, computed at the rate of 6 per cent per annum from the date or dates of payment, in accordance with Section 3771 of the Internal Revenue Code. These interest allowances are credited in the same manner against the aforementioned deficiency, and serve to reduce it accordingly.

Finally, the deficiency taxpayer receives a notice and demand for income tax, on Form 17A, from the Collector of Internal Revenue. The taxpayer is apprised of the amount of the deficiency ($60,000), of the amount of interest due thereon ($5,000), of the amount of overassessment credits ($30,000), together with interest thereon which has been applied ($2,500), and the net balance due ($32,500). The taxpayer then transmits his check to the collector of internal revenue for the latter amount.

On the assumption that the taxpayer has filed a timely claim for refund with the collector for the full amount of deficiency and interest thereon, and that said claim has been disallowed or that six months have elapsed since the filing thereof without any action having been taken thereon by the Commissioner, the taxpayer now institutes his suit against the collector in the

District Court of the United States for the district in which the collector resides.

TAXPAYER DILEMMA

The filing of a complaint against the collector is premised on the common law notion that monies have been illegally collected by the collector, and that the plaintiff's action is to recover such monies from him personally. The basic principle, therefore, is that payment must have been made to him.[6] Although at first blush it may appear that the entire amount of the deficiency and interest, totalling $65,000, has been paid to the collector because that was the initial amount set forth in his notice and demand, further consideration reveals that said amount was reduced by the overassessment credits and interest allowances emanating from the office of the Commissioner to produce the net amount, and this net amount, being $32,500, was paid to the collector of internal revenue.

Does this mean that the amounts made the subject of the overassessment credits and applied against the deficiency do not constitute payment to the collector for purposes of the suit? Apparently, that is the import of the Supreme Court's decision in *Lowe Bros. Co.* v. *United States.*[7]

In that case, the Supreme Court was presented with the question whether the District Courts of the United States had jurisdiction under then Section 24(20) of the Judicial Code (28 U.S.C.A. Section 41(20)),[8] of a suit brought against the United

[6] See *Sage* v. *United States*, 250 U.S. 33 (1919); *Smietanka* v. *Indiana Steel Co.*, 257 U.S. 1 (1921).

[7] 304 U.S. 302 (1938).

[8] Prior to 1921, Section 24(20) of the Judicial Code gave District Courts concurrent jurisdiction with the Court of Claims over suits against the United States when the claim did not exceed $10,000. Amendments to the Judicial Code, beginning in 1921, enlarged the jurisdiction of the District Courts to make it concurrent with that of the Court of Claims, of any suit or proceeding against the United States, commenced after the passage of the Revenue Act of 1921, for the recovery of any internal revenue tax or penalty or sum alleged to have been erroneously or illegally assessed or collected, even if the claim exceeds $10,000, if the collector of internal revenue by whom such tax, penalty, or sum was collected is dead or is not in office as collector at the time such suit or proceeding is commenced. (For the same provisions in the new federal Judicial Code, Act of June 25, 1948, Public Law 773 (H.R. 3214), see Title 28, United States Code, Section 1340.)

States to recover income and excess profits taxes in an amount in excess of $10,000 when the recovery sought was of an overpayment of 1917 taxes, effected by crediting against a barred deficiency for that year an overpayment for 1918 taxes. The facts showed that petitioner had overpaid its income and excess profits taxes for 1918, and that in 1924, the Commissioner had signed a schedule of overpayments by which he approved a credit of a part of the 1918 overpayment, in an amount exceeding $10,000, against a tax deficiency of petitioner for 1917, the collection of which was then barred by the statute of limitations. The collector in office in 1924, when the credit was allowed, having retired, petitioner brought suit against the United States, in the District Court, to recover the amount of the credit. The petition alleged overpayment of the 1917 tax by reason of the credit, and demanded its recovery.

In denying recovery on the ground that the District Court was without jurisdiction to entertain the suit, the Supreme Court pointed out that the obvious purpose of the amendment of 1921 enlarging the jurisdiction of the District Court to embrace suits against the United States to recover taxes in excess of $10,000 if the collector by whom such tax was collected is dead or out of office, was to permit a substitution of a suit against the United States for the suit previously allowed against the collector whenever the foregoing conditions were present. This, the Court stated, was made evident by the words of the amendment which authorize the substitution only when the collection is made by the collector when in office. In concluding, the Court stated, at p. 898:

As we think it plain that no suit could have been maintained against the collector to recover the alleged overpayment, it follows that the District Court was without jurisdiction to entertain the present suit. If the 1917 tax can be said to have been collected at all, as to which we express no opinion, it was collected by the action of the Commissioner in crediting against the 1917 deficiency the 1918 overpayment. In 1924, the year of the claimed overpayment, the collector received no overpayment of petitioner's tax for any year. If the 1917 taxes were then collected it was by virtue of the application to the 1917 deficiency of moneys already in the treasury. The collector

was without authority to make such application. It was the Commissioner's approval of the schedule of overpayments which was effective for that purpose. . . . The certification of the overpayment by the collector to the Commissioner, a mere ministerial act, could subject the collector to no personal liability.

It is true that under the statutes of the United States the collector is relieved from personal liability except in the case where the District Court is of opinion that he acted without probable cause, . . . and that such suits against the collector are commonly but a means of collecting the overpayment from the United States. . . . But no statute has enlarged the collector's common-law liability to suit, and we cannot ignore the words of the amendment of section 24 (20), 28 U.S.C.A. Section 41(20), which, in providing for a suit against the United States in lieu of one against the collector, make collection by him the sine qua non of jurisdiction.

The upshot of the foregoing is that if the taxpayer has instituted suit in the District Court, he may well expect to have dismissed for lack of jurisdiction that portion of his complaint which alleges payment to, and collection by, the collector of internal revenue of the amounts which were made the subject of the overassessment credits by the Commissioner.

Pitfalls for the Taxpayer

It may be reasoned by the taxpayer, that, inasmuch as the District Court has jurisdiction over the suit in so far as it relates to the amounts actually paid by him to the collector, it may be wise to prosecute it to conclusion in order to reap the advantages incident to a jury trial. The taxpayer may deem it a matter of caution, to forestall any possibility that suit may be barred thereon, to institute a contemporaneous suit in the Court of Claims for the amount of the overassessment credits, which constitute an account stated by reason of the certificates of overassessment previously issued by the Commissioner. It may be noted that the Court of Claims has jurisdiction to render judgment upon any claim against the United States founded, *inter alia,* upon the United States Constitution, or upon any Act of Congress, or upon any express or implied contract with the United States.[9] The taxpayer would thus far appear to be on safe jurisdictional ground.

[9] Title 28, United States Code, §1491.

But Section 1500 of the new federal Judicial Code prohibits the prosecution of a suit in the Court of Claims while there is pending in any other court any suit or process against any person who, at the time when the cause of action alleged in such suit or process arose, was, in respect thereto, acting or professing to act, directly or indirectly, under the authority of the United States.[10] This provision under the predecessor Judicial Code was effectively utilized by the defendant in *New Jersey Worsted Mills* v. *United States*,[11] by way of motion to dismiss the plaintiff's petition to the Court of Claims. It was there admitted by plaintiff that at the time the petition was filed with the Court of Claims, it had pending in the United States District Court for the district of New Jersey a suit against the former collector of internal revenue, based upon the same claim as the one upon which suit was brought in the Court of Claims, and at the time when the cause of action arose the former collector was in respect thereto acting under the authority of the United States. The Court of Claims, upon applying the statute to the facts of the case, found that plaintiff was not permitted to file its claim in that tribunal and accordingly sustained the defendant's motion to dismiss the petition.[12]

It could be urged, therefore, that the taxpayer may not prosecute his suit in the United States District Court and at the same time have his petition entertained by the Court of Claims. If he does not file a petition in the latter tribunal, he runs the risk that any cause of action of which it has jurisdiction may be barred by the statute of limitations prior to the time when his cause of action in the District Court has been completely terminated. Inasmuch as every claim of which the Court of Claims has jurisdiction will be barred unless the petition thereon is filed within six years after such claim first accrues,[13] risk in that regard is not entirely imaginary. A six-year period

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10 See §154 of the former Judicial Code (28 U.S.C.A. §260).

11 80 Ct. Claims 640, 9 F. Supp. 605 (1935).

12 To the same effect, see *Joyce* v. *United States*, 98 Ct. Claims 427, 32 A.F.T.R. 1681 (1943).

13 Title 28, United States Code, §2501.

is not an inordinately long period of time for a suit to proceed from beginning to end in the District Courts of the United States, taking into account the normal number of delays incident to the filing of pleadings, the making of motions and requests for postponements, the conduct of the trial, and the prosecution of appeals.

Suppose, on the other hand, that the taxpayer has successfully concluded his suit in the District Court and has been awarded a judgment against the collector in the amount actually paid to him. What about the amount of the overassessment credits?

If he forthwith institutes suit against the United States on the certificates of overassessment in the Court of Claims, it is true that Section 1500 of the new Judicial Code would have no application, because no suit would at that moment of time be pending in any other court. But could it not be urged by the defendant that there has been a severance of issues by the taxpayer, that he could have filed a petition in the first place in the Court of Claims to embrace the entire action, that he has already had a day in court with respect to the same issues, and that his petition ought therefore to be dismissed? In response thereto, the plaintiff could argue that any severance of issues was caused by the defendant, that plaintiff was entitled as a matter of right to bring suit in the District Court and demand a trial by jury, that pursuant to Title 28, United States Code, Section 2402, jury trial is denied in actions against the United States, and that the parties to the suits are different, the collector being defendant in the United States District Court and the United States being defendant in the instant cause. Without deciding whether the Court of Claims would grant a motion to dismiss the petition, let us assume that such a motion would be denied.[14]

What defense would the United States interpose to the

[14] The Supreme Court has held that a judgment against the collector in a District Court to recover a portion of taxes paid, not being a judgment against the United States, is not a bar to a subsequent suit against it in the Court of Claims for the balance paid. *Sage* v. *United States, supra,* note 6.

claims asserted by the taxpayer based on the certificates of overassessment? It is reasonable to assume that the defendant might plead payment by reason of the application thereof to the total tax deficiency asserted by the Commissioner. Would it not appear from the notice of deficiency, certificates of overassessment, and notice and demand for income taxes that the taxpayer's asserted deficiency was $60,000 and that the actual payment to the collector was $32,500, after crediting against the asserted deficiency the amounts which the related taxpayers consented to have credited in his favor? It would then be incumbent upon the plaintiff to show that no deficiency ever existed against him, that the alleged application of the overassessment credits to his deficiency account was abortive, and that the monies represented by such credits are due and owing to him. The Commissioner might proffer the argument that there was no account stated as between the taxpayer and himself, that any such account stated existed only between the Commissioner and the taxpayer's family members, in whose names the certificates of overassessment were initially issued. And the taxpayer might counter that with some other argument.

Alternatives and Conclusion

It is not our purpose to exhaust the tortuous and myriad avenues into which cross pleadings and counterarguments may lead the parties. It is sufficient if it be noted that there are many obstacles which confront the wary, and many pitfalls to ensnare the unwary, where a taxpayer desires to pay his tax, file a claim for refund, and institute suit on the claim, in a typical family partnership case. Two alternatives are, however, available to eliminate the risks hereinabove discussed.

The taxpayer, where his tax deficiency has been reduced by the application of overassessments credits emanating from his family members, might institute suit against the United States in the Court of Claims for the entire amount of the payment, consisting of cash actually paid to the collector of internal

revenue plus the amounts represented by the certificates of overassessment. The disadvantages to this procedure, however, are that trial by jury is lost, and that the proceeding may be more costly than if instituted in the District Court by reason of the requirement of the Court of Claims that pleadings must be printed.

If the taxpayer desires to proceed in the District Court, he should pay the entire amount of the deficiency to the collector of internal revenue and his family members should be instructed to seek refunds of their overassessments, rather than consent to the credit thereof to the taxpayer's deficiency. It may be that the taxpayer may not have sufficient funds to pay the entire deficiency and that he wishes to await the refunds to his family members so that he may utilize their funds. This would unquestionably delay the disposition of the matter. The taxpayer would be wise, in this latter situation, to make every effort to raise the money through some other means. Failing this, he might institute suit on the amount which he actually paid to the collector, and assume the risk of concluding suit within the period of limitations applicable to proceedings or claims in the Court of Claims.

It is submitted that the elimination of the whole problem would have a very salutary effect upon the administration of our revenues, as well as upon the attitude of taxpayers toward the Bureau of Internal Revenue and the collector's office. The layman finds it difficult to comprehend why the United States government should be in a position to receive monies with both hands and to effect refunds with only one hand.

In economic essence, is not the crediting of the overassessments tantamount to payment? If the credits were not applied, would not the collector be under duty to collect the entire deficiency? By the application of the overassessments, is not the taxpayer's account in the collector's office credited and reduced thereby, making a corresponding reduction in the amount to be actually collected by the collector? Should it be necessary to require a physical transfer of cash, because a common law

concept has been thus far perpetuated in our jurisprudence relating to internal revenue laws?

It is submitted that attention be directed toward the formulation of legislation to vitiate this remnant of our common law days. The matters of taxation and its collection and administration are intensely real. And there is no reason why the situation should not, and cannot, be brought from the realm of archaism into realism. It is thought that proper cooperation among taxpayers, taxpayers' counsel, and representatives of the Treasury Department, should be sought and utilized in the effectuation of that result.

CHAPTER XXV

VOLUNTARY DISCLOSURE POLICY

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Corcoran & Kostelanetz

THE PRINCIPLES of voluntary disclosure are universal and as old as tax collection. It is not our function as practitioners to pass on the essential morality of forgiving felonies by confession. It is sufficient to say that a former Chief Counsel of the Bureau of Internal Revenue has characterized the policy as being "good business" from the standpoint of both the government and the taxpayer.

Since application of the policy creates many problems, it would seem that a taxpayer contemplating disclosure should be in position to go to some authoritative source and thus be able to determine in advance what the answers to his questions could be. We do it every day in the law by looking up cases and authorities, and if we, as lawyers, cannot give a client an unequivocal answer, we can at least learnedly speculate as to what a court should decide. This effort seems useless when it comes to the voluntary disclosure doctrine. The *Lustig* case (163 F. (2d) 85, C.C.A. (2d), 1947) stands squarely for the proposition that a court will not review this administrative policy of the Treasury Department. Accordingly, we can be guided only by individual experiences, and since such experiences are unrecorded in either law books or periodicals, we speak only from our own knowledge and from what our colleagues tell us.

It seems that subordinate officers of the Bureau, who also do not have the benefit of an official clarification, have taken the position by and large that they are the Bureau's advocates and

generally have construed disputed questions against the taxpayers. They have even gone further. For instance, they have repudiated a portion of a public statement made by a former Chief Counsel. As far as I know, however, the repudiation was not publicly done.

It is clear that if the basic reason for the existence of the voluntary disclosure doctrine is that of bringing in revenue, the policy should be liberally administered. I for one feel that the important elements of disclosure are the conscious waiver of constitutional rights against self-incrimination, the revelation of fraud, and the attendant contribution to the revenue. If the policy is worth while at all, there is no reason why such a disclosure by a taxpayer should be discouraged. There definitely should be no reason why a taxpayer who has placed his head in the lion's mouth by making a disclosure should thereafter lose it by a technical and narrow construction of the policy. While rights of property are properly delineated in the law, it seems almost inconceivable that a matter as important as the liberty of a person is not so delineated. Yet that is the precise status of the voluntary disclosure policy; its narrow or technical view coupled with the impossibility of review in the courts raises a serious question as to whether the policy is worth while in the first place.

I say seriously, either let us have a voluntary disclosure policy which all of us can understand, or if that is impossible, let us consider whether it should or should not be abandoned.

CHAPTER XXVI

RULINGS

MARTIN M. LORE
Member of New York Bar

THE SUBJECT of rulings is one that is near and dear to the hearts of taxpayers. Nowadays federal taxes represent an important part of the net financial effect for the parties involved in a given transaction. I could go into a discussion of the scope of rulings, the types of situations in which a ruling can be obtained, and those in which the Bureau will refuse to issue a ruling, etc. But I am going to confine my remarks here to the use of Bureau rulings in connection with actual tax controversies.

Not all rulings of the Bureau are published; in fact most of them are not. The ones that are published are those which the Bureau feels are of general interest, either because they involve a novel question, or because they cover something that has never before been treated in any published ruling, or for any other reason. It is also the policy of the Bureau to publish any ruling which modifies or revokes a previously published ruling.

It has been suggested that all rulings ought to be published. It is questionable whether the advantages to be gained here warrant the terrific burden that would be placed upon the Bureau and its personnel, and whether the available manpower could not be more effectively employed in enforcement activities and other administrative functions. Others have suggested that at least all G. C. M.'s should be published, but even here the unpublished G. C. M.'s are presumably of little general

application, at least in most cases, and with the vast amount of reading matter turned out by the legislative, judicial, and administrative gristmills, such an innovation would probably not be welcome to many practitioners who are already hard pressed in keeping up with the ever increasing flow of tax matter.

I believe, however, there is a point to be made, and that is that whatever is unpublished, and therefore not available to taxpayers generally, the so-called confidential unpublished rulings, should not be used by internal revenue agents, conferees, or technical advisors in disposing of controversies. It is very disheartening to be informed by an agent that your position sounds quite tenable, but that in view of a confidential unpublished ruling he must decide against you on the issue. It is like trying to fight an invisible man. You feel that if you could only see your adversary you might be able to lick him. The Bureau recognized this in the change in procedure recently inaugurated whereby a taxpayer is now notified in any case in which a field office receives technical advice from Washington and the taxpayer is given an opportunity to have a conference in Washington.

An unpublished ruling is sometimes given greater weight than a published ruling. In the case of a published ruling you can study it, compare the facts, argue as to which are its salient features, and the applicability or nonapplicability of the ruling to your situation. In the case of an unpublished ruling you cannot do that. Perhaps the ruling is inapplicable. Perhaps the agent has patently misinterpreted it. You have no way of satisfying yourself that none of these events has occurred.

Occasionally in the technical staff a few sentences will be read from an unpublished ruling, perhaps to show the line of reasoning. This is embarrassing from the standpoint of the government's representative, and often very elusive so far as the taxpayer is concerned. It is akin to a quotation in a brief. The impression conveyed may be quite different from that obtained from a reading of the passage in its context.

The government is not totally unaware of this predicament. In fact the Bureau states that no unpublished ruling is to be cited or relied upon by any of its officers or employees as a precedent in the disposition of other cases. Recently the Bureau even changed the name of confidential unpublished rulings. They are now known as advisory memorandums, numbered in sequence. Apparently the idea is to regard these advisory memorandums more or less in the nature of interoffice memoranda. The fact remains that in actual practice they are relied upon and do form the basis of action in other cases. If they are not to be published it would seem that a greater effort should be made by the Bureau to prevent their being used by agents and others as precedents for disposing of cases believed to be similar.

CHAPTER XXVII

ACQUIESCENCE BY COMMISSIONER IN TAX COURT DECISIONS

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Alvord & Alvord

ONE of the most important guideposts for federal income tax practitioners is the action taken by the Commissioner of Internal Revenue after a decision in favor of the taxpayer has been handed down by the Tax Court. As soon as possible after such a decision, the Commissioner announces that he acquiesces or he nonacquiesces in the result.

This announcement is made in order to create a precedent which can be relied upon by Bureau officials in disposing of other cases. It is a very useful device because it avoids the necessity for protracted disputes on settled issues and it helps to dispose of cases more rapidly than would otherwise be possible.

I think the practice might well be extended to District Court decisions and perhaps to decisions of the Circuit Court of Appeals.

In the case of a device such as this, which is so helpful, why should tax practitioners have any complaints? They do complain very often. The usual burden of their complaint is that a Bureau official has seized upon an immaterial factual difference between the decided case and the case before him as a pretext for not following the acquiescence and deciding the issue in the taxpayer's favor. In the official's defense, it should be pointed out that there are often valid grounds for an honest difference of opinion as to the materiality of par-

ticular facts. If the Tax Court decision leaves any doubt as to the material facts upon which the result turned, a conferee cannot be blamed for refusing to concede the same result under different circumstances. This attitude, however, often produces a stalemate which should be avoided, if possible.

There is a remedy which would help to dispel uncertainty in the minds of Bureau officials in many of these cases. After a decision adverse to the Commissioner has been issued by the Tax Court, the legal staff of the Bureau has the responsibility for recommending whether an appeal should be taken to the Circuit Court or whether the Commissioner should acquiesce in the decision. The recommendation is supported by a memorandum explaining the significance of the decision. Any such memorandum must of necessity set forth the material facts upon which the Commissioner's attorney believes the Tax Court's decision was based.

This part of the memorandum should be published to explain the Commissioner's acquiescence. If this were done, Bureau officials and employees would have a clear and definite indication in every case as to the exact circumstances in which the Commissioner intends the decided case to be used as a precedent. In some cases, this definiteness would prevent a tax practitioner from claiming the benefit of an acquiescence. Any such limitation of its scope, however, would be well worth while if it were accompanied by a greater readiness on the part of Bureau officials to follow these precedents in situations where such reliance has been clearly authorized by the Commissioner.

CHAPTER XXVIII

LAW GOVERNING THE TRIAL OF LITIGATIONS

JAY SLONIM
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WHAT I want to suggest to you is that there should be a change made in the law governing the trial of litigations in the Tax Court. To point up the suggestion, let us proceed by way of example. Let us assume a situation with which I imagine all of us are more or less acquainted.

Suppose that you are a businessman, a policy-making executive in a corporation. And suppose that your concern has run into a good year and has made some real money—so that you see a chance finally to do some of the things for the good of the business that have been popping into your mind from time to time. For instance, you have a chance to expand, to modernize, and the like. Or perhaps, on the other hand, you have been pessimistic rather than optimistic. Maybe you have been worried about the possibility of a severe drop in business within the next few years, and you have got some unpleasant memories of what occurred during the last depression, so that you'd like to use this as an opportunity to build up a cushion for the company to fall back on if future need arises.

In any event, whether because of optimism or pessimism, you do think that now is a good time to start saving up, to accumulate something, in order to accomplish the things which you have in mind to do for the good of the enterprise.

Consequently, instead of passing out the profits by way of dividends to the stockholders, you cause the corporation to hold on to them, to "accumulate" them.

So far, so good.

But then a couple of years later (going along with our example) an internal revenue agent comes to your office, and makes his examination of the corporation's tax return. In the course of events he notices the accumulation, points to Section 102 of the Code, and says that he's afraid that your corporation will have to pay the extra tax which can be levied under that provision.

So you call in a tax man, who does the best he can to straighten him out. He tries to convince him that "102" does not apply—that there wasn't anything in anybody's mind about helping any of the stockholders duck their surtaxes. He tries to make him understand that it really was for the good of the business that this accumulation was made. But he isn't able to satisfy him.

It's not that the revenue agent simply is trying to make trouble for you. You can see clearly enough that that is not the cause of the difficulty. On the contrary he seems to be sincere, he's courteous, and he doesn't run around yelling that you are all a bunch of crooks. No, it's nothing unpleasant like that.

It's just that you can't make him see things your way. Why not? Well, the way you size it up, at bottom it's all due to his limited viewpoint—a limited viewpoint which blocks him from recognizing that the business actually did have occasion for that accumulation.

On top of that, you seem to find yourself running into pretty much the same problem all the way up the line, when you are dealing with the other government lawyers and accountants who are reviewing the matter. Fine, honorable men all of them, who no doubt know by heart every provision in the tax law, and know all its technicalities inside out. But as a harried businessman, it seems to you, the trouble is that they're tax technicians, instead of businessmen.

Ultimately, this state of affairs has got you pretty well down in the mouth, especially because of your growing conviction

that if only there were a real businessman among them, he would be able to sense instinctively the correctness and the truth of your story.

But then you console yourself with the thought: Well, anyhow, after all I'm in the United States. This is one country where we have a right to a trial by jury, and if we do have to go to court about this matter there's a reasonably good chance that there will be somebody on the jury who has had to meet a payroll himself. Somebody who knows, from his own personal experience, what it means to have to rush around trying to get business and trying to keep a business going; someone who realizes that a man can't always dot all the i's and cross all the t's and go through all that red tape that the lawyers and accountants in the government seem to think is necessary.

So you are encouraged by the thought that someone on the jury, at least, will understand what your true state of mind was and will therefore perhaps bring about a decision in your corporation's favor, after all.

Now that is where you get a rude awakening. (And that, incidentally, is where we at last start drawing near the point of this rather long-winded example of ours.) For when you mention your hopes respecting the jury to your tax man, he holds up a warning hand and cautions you not to count too much on being entitled to have your trial conducted before a jury. He informs you that in order for a taxpayer to be sure of being able to have his tax liability determined by a jury, it is necessary for him first to be able to raise the money with which to pay the tax. To help you understand the picture, he outlines to you the procedure which customarily is followed in order to obtain a jury trial of a tax controversy: first pay the tax, then file the claim for refund, then wait half-a-year, and then finally sue the appropriate collector in the United States District Court.

You are aghast at this and exclaim that you can't do it, that

the business has made commitments which have frozen the money in the business, and that it would be ruinous for you to have to try to raise the money with which to pay the tax now—a tax which, worst of all, you feel the company doesn't actually owe anyhow and which it shouldn't have to pay at all.

Your tax man then tries to reassure you by telling you that even if you cannot afford to pay the tax in advance you still can contest the matter in the courts. He says that you can thresh the question out in the Tax Court without first paying your tax.

He points out that it is this very feature which—together with the likelihood of getting a speedier court decision as a result of by-passing the half-year's delay that is normally involved in refund suits—is perhaps the chief reason why so many tax cases are brought to the Tax Court. But, he warns you, if you go to the Tax Court, you cannot have a jury trial.

That's the law. And there's the rub. In other words, although your inability to pay the tax does not deprive you of the right to litigate the issue, it does operate to deprive you of the right to a jury trial.

This causes you (our suppositious businessman) to wonder at the lack of fairness in an arrangement like that. After all, you are sufficiently honest with yourself to realize that you are probably prejudiced in favor of your own case, and that, therefore, you may be unjustly critical of the people who represent the government, and that even if you were to have the definite right to a jury trial nonetheless the members of the jury might well decide against you, too. But in any event, you would like to have the opportunity to have your problem passed upon by a jury, and as a general proposition you are impressed by the apparent inequity of the existing setup.

Where, you ask yourself, is the justice in that? Why may a man who can afford to pay a tax, have a jury trial—while a fellow who cannot afford to pay it, may not have a jury trial?

Why should a man who wants to avoid the delay which is characteristic of the refund method, be penalized by having to forego a jury trial?

This is a serious deprivation. The opportunity to have the facts in his case weighed by an entire jury rather than by a solitary judge can be of vital importance to a taxpayer. Just how great a difference it can make has been demonstrated by the history of the various family partnership litigations, to take merely one type of tax controversy as an illustration. There are any number of other kinds of tax disputes whose outcome likewise might well be profoundly affected by having a jury, rather than a judge, make the decisions of fact. Yet as things stand now the taxpayer who, either because he is short of cash or needs a speedy determination, resorts to the Tax Court rather than the District Court, loses this valuable privilege of a trial by jury.

Why shouldn't a taxpayer have available to him in the Tax Court the same privilege to a jury trial that would be available to him in the District Court?

That is the question that I want to leave with you. Why should there not be a law to make it possible to have the issues tried before a jury in the Tax Court, just as they may be tried before a jury in the District Court?

CHAPTER XXIX

LACK OF PROPER DIRECTION OF POLICY

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THERE ARE two simple cases that I want to put before you. Each of them illustrates what I feel to be a fundamental fault in the administration of our tax laws. I want to see if you agree with me that the mistakes which were made were not made by any agent in the field or by any trial lawyer, but by persons much higher up in the administration of our tax laws. I want to see whether you agree with me that something is grievously wrong with the organization of the Commissioner's office and the Chief Counsel's office when such positions as were taken by the government in those cases are permitted to be taken to higher courts even if inadvertently they have been presented in lower courts.

The first case is that of *Airway Electric Appliance Corporation* v. *Guitteau.* Let me simplify the real issue involved by reducing the case to figures. A corporation on an accrual basis sold an appliance worth $100, receiving $10 cash and a note for $90. Under its arrangement with its distributor, it owed the distributor $10 as a commission for the sale, but the distributor would not get it until the last $10 had been paid by the purchaser. The Commissioner held that all $90 of the note should be accrued as income to the corporation, but the Commissioner refused to reduce this income by the $10 which was accrued by the taxpayer as a liability to the distributor. It should have been obvious to anyone that if this last $10 was accrued as income, it must of necessity be accrued as a liability since

under no conceivable circumstance could the corporation get that last $10 and keep it. Yet, the District Court decided that the Commissioner was right, and the case had to be taken to the Circuit Court of Appeals before it was established that the Commissioner's contention was unfounded. The case is found at 123 F. (2d) 20 (C.A. 6th, 1941).

The second case, though not quite so simple, is really not very complicated. It involves the additional fault of the Commissioner in having made misuse of a curative statute which the Treasury had persuaded Congress to pass in order to save the Commissioner from being mistreated by taxpayers. The situation to which I refer is that presented by Section 24(c) of the Internal Revenue Code.

Before Section 24(c) was passed, it was a common practice for closed corporations on the accrual basis to accrue salaries to the principal stockholders and take a deduction for those salaries, while the stockholders, being on the cash basis, were not required to take into their personal income the amount of that accrual. Accordingly, sometimes the situation would go on for years with the corporation getting regular deductions for salaries, but without the principal shareholders paying any personal income tax on those salaries. This was clearly wrong and was a loophole which needed to be remedied. The Commissioner asked Congress to remedy it, and Section 24(c) was the result. No one had the least doubt about the reason that Congress passed that statute. Yet the Commissioner's application of that section has been so technical and so out of line with the purpose for which it was passed, that the statute has been used in some cases as a means of denying a corporation the deduction while at the same time taxing the taxpayer on a salary.

The situation about which I speak is that presented where a taxpayer would have a right to claim a salary from the corporation if he wanted to take it, and therefore is taxable personally on a theory of constructive receipt. Here the Commissioner has taken the position that the taxpayer is taxable on the

salary because he constructively received it, but the Commissioner refuses to recognize that the corporation should have a corresponding deduction. Here again is an example of the administration of a statute out of line with any sense of fairness and with the purpose for which the statute was passed.

The language of the statute did not demand any such unfair construction, and I do not think that any such construction should ever have been presented to our courts. Yet various cases have been taken up through appellate courts, and certiorari applied for to the Supreme Court of the United States when the lower courts held that the Commissioner could get by with what he was doing. Certiorari was denied, and it is now necessary to get Congress to pass another special statute to correct the result of the Commissioner's action in applying Section 24(c) as he has applied it.

I would like to read a paragraph or two from an *amicus* brief which we filed in the Supreme Court in one of those cases. We had settled the case in which we were interested, and therefore had no financial interest in what the court did, but we did feel that something was very wrong with the administration and that it ought to be straightened out.

> The voluminous amount of such litigation in this Court is symptomatic of the large volume of tax controversy, much of it avoidable, which now plagues the Courts, the Treasury and the taxpayer. The present case affords an opportunity for this Court to see clearly into one of the chief causes of the difficulty, and could do much to alleviate the situation by making a frank statement definitely and openly placing a large part of the blame where it belongs. The willingness of the Commissioner of Internal Revenue to make such an unfair, extreme and unfounded contention as underlies the present controversy, illustrates with a clarion air of simplicity unusual in the tax field one of the primary causes of the increasing volume of tax litigation.
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> That is the apparent unwillingness of the person charged with the administration of the tax laws, failure to decide questions constantly presented to them and to keep out of litigation questions which sound and fair administration would dictate should not be litigated. Because this evil is so clearly posed in the present case, this court wishes, clearly and forcefully, to point out the faults in the administrative process, which is defeating all efforts to achieve simplicity in our tax laws.
>
> We believe that such action by this court would have a most salutary

effect and that it might greatly restrict the volume of tax litigation and alleviate the burden of taxpayers, of the courts and of the Treasury.

When we come to the general discussion, I hope that someone in the audience who feels that the cases I have given do not illustrate some fundamental faults of administration, will speak up and attempt to justify them.

CHAPTER XXX

THE NONACQUIESCENCE WEAPON

CHARLES W. TYE
Tax Counsel, Royal Liverpool Group

THE ADMINISTRATION of our intricate and voluminous tax laws is, to say the least, a most difficult undertaking. The Bureau of Internal Revenue is charged with this administrative responsibility, and I believe it is generally agreed that it has done a splendid job. However, the tax profession has been unduly hampered by certain administrative procedures which tend to make difficult, if not impossible, the day-to-day rendering of necessary tax advice to clients.

Specifically, I have in mind the Bureau practice of nonacquiescing, but not appealing, important lower court tax decisions. Although there is a place in our system of taxation whereby the Bureau may advise through published acquiescence its willingness to abide by Tax Court and lower court decisions, difficult problems are presented to the tax practitioner where the Bureau refuses to appeal important tax litigation favorable to the taxpayer, and at the same time refuses to be bound by such decisions. It must be realized, of course, that it would be impractical for the government to appeal all litigation unfavorable to it, and no doubt there are situations where nonacquiescence, without appeal, is entirely proper. But, if the Bureau forces the taxpayer to litigate matters which involve important substantive principles of law, as distinguished from essentially factual controversies, and thereafter refuses to appeal but continues to litigate the issue in other jurisdictions or before the Tax Court, the tax profession is

either forced to follow the position of the Bureau or to embark upon a contrary program knowing that litigation will result.

I believe the Bureau should either be required to appeal decisions involving important substantive law principles, or be bound by such decisions. It should not have the option to force litigation upon a taxpayer and then to arbitrarily refrain from appealing if the decision is unfavorable. The nonacquiescence weapon should be curbed not only to eliminate multiplicity of suits, but also to enable the tax profession to utilize, with a degree of safety, lower court decisions which have not been appealed by the government.

CHAPTER XXXI

FINALITY OF ADMINISTRATIVE SETTLEMENTS

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New York University

THERE ARE some ten thousand administrative settlements, in cases involving proposed income tax deficiencies, concluded each year in the field offices of the technical staff. I want to comment upon the phase of those settlements having to do with their finality.

All tax practitioners are familiar with the Bureau Form 870 which is used in the office of the internal revenue agent in charge, in connection with settlements of proposed deficiencies there. In signing such a form, the taxpayer waives the restrictions upon the assessment of a deficiency in a stated amount, primarily for the purpose of stopping the running of interest.

It is a matter of common knowledge that despite the filing of such a waiver, the Commissioner has the power to assert additional deficiencies and not infrequently does so. Similarly, the taxpayer may change his mind after the deficiency covered in the waiver has been assessed and paid. In that event, the waiver does not preclude him from claiming a refund. In other words, the ordinary 870 does not represent a final settlement, although from a practical point of view, it usually has that effect.

I want to speak, however, of the special form of 870, known as the TS870, which is used in the technical staff. That form, like the regular form, involves on the part of the taxpayer, a waiver of the restrictions upon the assessment of the stated deficiency, so that the Commissioner is free to assess without a

90-day letter and without being limited by the other restrictions upon the assessment of a deficiency which are provided for in Section 272(a) of the Code.

Unlike the ordinary 870, however, the form generally in use by the technical staff includes additional language by which the taxpayer agrees not to file a claim for refund, and upon request, to execute a closing agreement. Everybody knows that under express provision of the Code, a closing agreement does represent a final administrative settlement, binding both the taxpayer and the government, but that it is a very cumbersome sort of procedure to go through.

Now, I suppose, ordinarily when taxpayers enter into a settlement with the technical staff, they contemplate adhering to it, but a lot of things can happen which may lead to a change of mind, such as a subsequent court decision against the Commissioner in a similar case involving another taxpayer.

Whether for that reason, or for some other and less laudable reason, taxpayers do, from time to time, try to back out of such settlements and claim refunds contrary to the express language on the form by which the taxpayer has agreed not to file a claim for refund. That action has led to a considerable amount of litigation in which, notwithstanding the necessary admission that the TS870 is not a closing agreement, the government endeavors to defeat the refund action on procedural grounds, saying that the taxpayer is bound by what he agreed to in this special form of 870.

I don't propose to go very far into the law involved in these cases. In some of them, the issue with respect to which the taxpayer is claiming a refund is one which did not enter into the negotiations which preceded the settlement. In others, the issue on which a refund is claimed, is one which was expressly discussed and agreed upon in the administrative conferences or negotiations. Another difference exists in the cases. Apparently in some of the field offices, the technical staff has stricken out the language in the form by which the Commissioner reserves the right to assert additional deficiencies. The thought

apparently is that you thus have an agreement which possesses the element of mutuality, and consequently the taxpayer can be held to it on some sort of contractual principle.

I have not occasion here to analyze the legal questions involved, or to express any opinion on them, except to say that the law is in a very confused state, and it is, therefore, quite obvious that litigation is going to continue on this question, unless something is done to change the present Code.

Various recommendations have been made. The 1938 revenue bill, as approved in the Senate, contained sections which would have authorized the execution of closing agreements under rules and regulations to be promulgated by the Commissioner with the approval of the Secretary. Under that provision, the Commissioner could have delegated the power to enter into legally binding settlements of this kind. That provision did not become law, however. There have been other proposals to confer power upon the head of the staff division in the field to bind the government legally by these administrative settlements and at the same time conclude the taxpayer in accordance with his agreement.

I can't see anything to be said against that kind of a change. The technical staff settlements are conclusive as a practical matter on the Bureau side, and I have not been able to see how making them legally conclusive would involve any conceivable setback to the government's interest. Moreover, it seems to me desirable that if the government is to be bound, the taxpayer should be bound too. If such a change were made, you would eliminate what is otherwise going to be a very considerable volume of future litigation, with results that must remain in doubt.

Both the Secretary of the Treasury and the Commissioner have recently indicated that they would be in accord with a change in the law which would eliminate the necessity of obtaining the Secretary's approval on some kinds of closing agreements. I don't think such a change would quite meet the difficulty that I am talking about, because you would still have

the necessity of going through all the usual rigmarole in the Washington office of the Bureau, so that settlements in the field office of the technical staff might still be lacking in the desired finality.

CHAPTER XXXII

GENERAL DISCUSSION AT PRACTITIONERS' ROUND TABLE

Mr. Lasser: Gentlemen, you have heard a quantity of controversy. At least, we recognize that there are some difficulties involved in the administration of federal income taxes.

The problem of the committee in arranging for this session was to make certain that various viewpoints would be expressed, or at least that the taxpayers' gripes would be expressed for the benefit of the record. We lately have begun to get an opportunity to be able to present criticisms of administration to the Bureau and sometimes to a Congressional committee more emphatically via a record of this kind. Our great hope is that through this medium, we may continue the presentation of such criticisms.

We are now about to start what I hope will be an hour discussion by your panel, and by yourselves, if you have any question. This discussion period will be conducted by my associate, Mr. Chase.

Mr. Chase: I should introduce this discussion by saying that you have heard fifteen different problems discussed by fifteen separate individuals. They were constructive criticisms, and each of us has contributed what he thinks is a solution to the problem.

For the purposes of the record, however, I think it fair to say that there isn't one of this group up here, or one of the group in this audience, who would trade their present practice for any other phase of accounting or tax practice. We all recognize that in our practice as tax practitioners, we deal with the

government of the United States, which is the most pleasant kind of an adversary in any kind of litigation.

Further, for every word of criticism each of us has, many words of praise for the tax administration in the United States are expressed.

Charles D. Hamel: My remarks relate to the criticism which was made by Mr. Friedman, with reference to the consideration of so-called standard issues, where deficiencies are involved and Section 722. I should like just to recall a little incident. If you will recall the hearings before the Joint Congressional Committee, the most frequent criticism that was made was the fact that in the consideration of 722 cases, under the procedure then existing in the Bureau, standard issues were considered with Section 722 and that people in the Bureau were using either one or the other as a club to get concessions.

In other words, they were going through a trading program. The criticism of that practice was more general than any other criticism, I think, in the hearings before the Joint Committee. I think it was one of the very important factors that finally led to the suggestion, on the part of the Commissioner, for the creation of a special group in the Bureau which would have jurisdiction solely in 722 issues.

One of the primary purposes would be to get away, in the consideration of 722, from all of the other issues there might be in the cases. I had the privilege of serving as the Chairman of the Council when it was created, and we did have occasions, Mr. Friedman, when a taxpayer came along and wanted the standard issues considered in connection with 722. While I was chairman, I took the position that we had no objection to the consideration of all of those issues together, if a taxpayer wanted to do it that way. In so far as we were concerned, we could consider only Section 722, but we were willing to give our consent to the joining of those issues and letting them be considered jointly, and we did so in a number of cases.

So, I believe that if you make the proper request, if you

have a case of that kind where you want to consider all the issues, I believe you can get consent.

MR. FRIEDMAN: Do you mean that the request should be made to the Bureau in Washington instead of to the local office?

MR. HAMEL: Well, I think as a practical matter this is the way it will work. You go to the revenue agent's office and you tell him you want the issues considered together. If he says "no," under the procedure set up, Section 722 must be considered by the Council. If you take it up with the 722 chairman in the revenue agent's office and ask him to get in touch with the Council you will probably find it is satisfactory to the revenue agent's office.

That's the way it has been done in several cases. They have come to me and I have said: "Why, of course. It's your case, if you want it done that way, it's just one less case for us."

MR. CHASE: Any further comment? If you differ with anything we have said up here, it will add to the constructive benefit of this record. Again, if you have questions, we want them.

PAUL SEGHERS: In the main, I agree with your praise of our system of government and I join with you in thanking God we live under that system, but I do not feel we ever have to apologize for criticising the government. I think we have got a good government because men in the very beginning were willing to get out with a gun and fight the government when it was found necessary to get justice. Otherwise, I think we would have a whole lot more evils to complain of, even in tax administration. I don't think there is any other branch of the government that is as well administered as the tax administration, and I think the reason is because there is more intelligent criticism of it, and there are more people ready to get on their feet and point out any errors and inequities.

I think there are always a lot of things that are bad and that need to be corrected, and we should always remember that in criticizing we are not only correcting the evils we complain

of, but we are preventing others. We are maintaining our freedom, and every time our freedom is stepped on I don't mind our hollering loud and referring to Hitler and Mussolini, because there are instances where the administration and where the courts attempt to legislate, and under our form of government, they have not the right to do it. They have sworn to uphold the Constitution, and under that they should administer the law as it is, and not as the judge wants it to be, and so I don't believe in apologizing for a minute.

I'm all with Mr. Sutherland: I believe in fighting against injustice and talking about it. If we stick together, we'll keep tax administration on its high plane.

One of the Supreme Court Justices once said that the power to tax is the power to destroy, and where there is such a power of destruction in the hands of a relatively few men, we must fight against anything that gives them discretion. We must fight for law and not for whim in determining whether we will exist or whether we are going to live. So let's get plenty of criticism and let's not feel that we have got to apologize for it.

We know we're proud to live under this government. We're thankful for it. But let's criticize. They are getting enough praise from other sources.

JOSEPH FIELD: My question is very brief. There's been a great deal of criticism of the secret memoranda and unpublished rulings upon which the Bureau usually seems to rely. So many of these are controversial. I wonder why it might not also be possible as a further extension of that criticism to try and get the Bureau to put its cards on the table when they do propose deficiencies, as they used to do ten or fifteen years ago.

In the old days, we used to come in with the conferee and usually with the revenue agent, put our cards on the table and say: "Based on these cases, we think we are entitled to this decision." But now, when you get the thirty-day letter or in your conversation with the agent or with the conferee, it's all a deep, dark secret, and about all you ever get out of them is

that this item is not deductible under Section 23-A. Would it not be possible to urge the Bureau to go back closer to their former procedures of disclosing a little bit more of why they believe the tax is owed, in their reports and in their conferences, in order to get more frankness and handle the whole thing and settle it before we have to get to the litigation stage?

MR. CHASE: It surely would be desirable. Mr. Slonim, would you like to comment on that a little further?

MR. SLONIM: I want to say, in fairness to the Bureau, that so far in my own experience with conferees—which, I must confess, has been gained largely in the one year which has passed since I left government service—they have been quite frank in telling me just why it was that they thought such and such a thing should be disallowed.

For example, there is very fresh in my memory a conference which I had only about two weeks ago in Buffalo. The conferee there was, as I said, extremely frank with me—and his actions were entirely consistent with the rest of my experience so far this year.

And, I must add, that likewise was consistent with what I had experienced years ago, before I went with the government.

MR. SUTHERLAND: I suppose that Mr. Slonim knows the reason given by the people in the Bureau. I understand that the persons in charge of administration in the Bureau stopped making those letters definite because they had been advised by the lawyers advising the Commissioner that that was not the smart thing to do. These lawyers evidently approached the problem not from the standpoint of an effective administration of the tax laws, but rather from that of a smart litigant who does not want to have his hands bound when he goes into court.

I feel that a great deal of the trouble we have in tax administration has come from a lack of proper direction of policy in the Chief Counsel's Office. For example, take the two cases which I mentioned earlier in the evening. I feel confident that in those situations the administrators of the tax law did not

wish to take the positions that they finally took, but that they were directed by their legal advisors to do so. I feel that some reorientation in the Chief Counsel's office is very necessary.

I had hoped that some of the criticisms I made earlier would provoke some defense of the Bureau's action in the two cases I mentioned. If there is anyone here who wishes to defend the Bureau's action I would certainly like to hear it.

MR. CHASE: Mr. Gardiner. Mr. George Gardiner is with the Bureau, Third District, New York, in charge of Pension Trust Division. Will you please take the mike?

MR. GARDINER: I just want to say that the criticism of the revenue agent's reports, in not putting anything more in his report than is required, is necessary, because that report is an exhibit before the Tax Court, and the revenue agent can destroy the whole thing if he writes a lot of details.

MR. CHASE: Well, that begs the question we're raising.

MR. FERNALD: I think this comes right down to the point of an unwillingness to put the cards on the table, an unwillingness to have the reasons for the Bureau's actions disclosed to the taxpayer, a lack of confidence in the work of the agent and of the Bureau, so the Bureau is not willing to have its acts and the basis for them publicly disclosed.

I do not think that is the way to get good administration. I think that the government, if it expects to win the confidence of the taxpayers, must be ready to have the acts and reasons of its subordinates subject to careful scrutiny and must be ready to withstand any attack against errors.

MR. GARDINER: I wouldn't agree with that, because I know that anybody who goes into conference and goes into the Tax Court, gets all of the discussion on all the facts of the issues of law all brought out. But, if you're going to take a document to a tax court which is an exhibit, the government has to protect itself in what it puts in that document. It can't leave itself wide open and have someone destroy the issues.

MR. FERNALD: If an issue is properly raised what is there to destroy? If it is in error, why should it not be destroyed?

MR. GARDINER: The Bureau has the problem of administering the tax law, and we have a Code. That's all we have. We only have to prove that the deduction is not deductible under the Code, that's all.

MR. FERNALD: In other words, the taxpayer cannot have confidence in his Bureau then, can he, if it is going to stand opposed to him and protect itself. If so, the taxpayer can not expect to get justice within the Bureau, but he must go up to the courts and ask the courts to stand behind him to support him against the administrative power of the government.

MR. GARDINER: No, it is a matter of administration, and you can't bring out the whole issue and everything in detail in the documents to be used as a basis for a suit.

MR. CHASE: Well, that seems to be the problem directly at issue.

MR. SEGHERS: My first comment is that I heard something that I never expected to hear a government man say, that the government must prove that something is not allowable. My understanding of the law of which I have been reminded many times by government men is that they don't have to prove anything.

By fiat they are always right and the taxpayer can only escape if he proves his side. Now, I have had the actual experience in a deficiency notice, of having the Bureau state that an item was not allowable under a section as a deduction. In order to contest that it was necessary to imagine what grounds the government was basing it on. It meant that in filing a petition there was no joined issue.

I think that Congress should demand that the Bureau do exactly what was intended, that when the taxpayer goes into court that the issues should be joined. The Commissioner should state why he thinks the tax is due. That is especially true since the Commissioner has the presumption of correctness. If he is presumed to be correct, at least he should state what his reasons are, or at least what is the background, and not merely a mere conclusion that you owe the tax.

Many deficiency notices today, in effect say, you owe this much tax because you owe it, period. I think that it is a great wrong not to disclose the truth as to why it is due. Of course, that method makes it easier to win a case. If I could go into court for my taxpayer and anything I said was presumed to be correct, why, I would simply say, "I don't owe any tax," and let you prove that I owed it.

But unfortunately that isn't the law. You go in and say, "You owe this tax," and it is presumed correct. Now, if you are going to have the weight and the benefit of that presumption, you certainly should disclose on what it rests, especially since you are not supposed to be an advocate for revenue, but one who is attempting to obtain justice and determine what is legitimately due from the taxpayer.

I don't think it is a matter of tricky procedure. Certainly, as I say again, an advocate who can go in and conceal all of his grounds and simply say, "You owe the tax," and have a presumption in his favor, if he is only interested in winning cases, that is all right. But if he is trying to find out what is just, it isn't all right.

MR. DIAMOND: Frankly, I don't know why I should be speaking for the government, since I am no longer on its payroll and am not getting paid for what I shall have to say.

One cannot be in the government service for nearly a decade and not come away with definite impressions concerning the problem underlying our discussions today. The entire problem just mentioned has fundamental roots that should be considered. Notwithstanding my maverick remarks at the opening of my formal speech, I do realize that as long as there are many different human beings in the Bureau of Internal Revenue who make decisions, there are going to be many human problems.

Parenthetically and by way of digression only, one of the real reasons why we have many of these surface difficulties, is that contrary to what many believe, appropriations for the Bureau of Internal Revenue are still too low. Coming back to the question of relationship of the Bureau and the taxpayer which

we are here discussing, I think there are several fundamental things to be kept in mind.

In the first place, let us disabuse ourselves of the theory that the Bureau people know or should know more what the law is than what the taxpayers themselves say the law is. In other words, the Bureau many times is just as much in the dark as the taxpayers themselves. The words are the words of Congress, and many times the men in the Bureau are just as much confused as their adversaries on the outside. Often they do not have any better or more esoteric understanding of the words than the taxpayers or their representatives.

Secondly, I think that the next thing to disabuse ourselves of is this: The government stands in a unique position, namely it is buffeted by contrary and conflicting notions of taxpayers. We talk here today as if all taxpayers agree on what the law is or what it should be, and consequently, it is so easy to give the Bureau the devil for being allegedly inconsistent.

Actually, there are as many notions of what the law is, or should be, as there are taxpayers.

For example, I am confident there is no one in this audience who would have agreed that a claim for refund of income, estate or gift taxes filed more than three years from the date of the return or more than two years from the date of payment could ever be timely. Yet some taxpayers were willing to argue that such claims could be filed, in certain instances, within four years from date of the return. For reasons yet unfathomable, they got District Courts and Courts of Appeal to agree with them and it took a decision by the Supreme Court of the United States (*Jones* v. *Liberty Glass Company*, 330 U.S. 850) to knock them all down and point out that the entire controversy was in effect nonsensical.

I admit there are many instances where the Bureau representatives do the same thing but I know such action is not born of any deep-seated desire to harass taxpayers or merely to be arbitrary. Whereas each taxpayer generally protects his own interests only, the Bureau does in a real sense protect the

interests of us all. What may appear harsh and unjust in an individual case or in a class of cases may in fact be salutary for the public generally.

I think the time is in the making when we shall establish opportunities for a long and honorable career in the Bureau. When we do that and pay men enough money so that they will be willing to stay in the Bureau and not have to rely on other sources of income, good or bad, many of these problems will disappear, including this problem of the Bureau, the Treasury, and the Department of Justice, many times being afraid to put all their cards on the table.

PART SIX

STATE INCOME TAX ADMINISTRATION

CHAPTER XXXIII

GENERAL APPRAISAL OF STATE INCOME TAX ADMINISTRATIVE PROBLEMS

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THE PROBLEMS of good state income tax administration are also the general problems of administering any government activity. The primary requirements are therefore a well-written law and competent personnel who are largely free from political pressures.

What I have to say regarding income tax administration will be better understood if at the outset I state some of my general prejudices. First, I believe that a tax should be collected so that the taxpayer is as little aware of the tax as possible. To my way of thinking, a hidden tax possesses an administrative advantage over a tax not hidden. Second, I favor a tax which a taxpayer can pay with as little trouble as possible. Simplicity is desirable even though it may result in some injustice. Third, I believe that a tax directly related to the provision of a government service is to be preferred over one only indirectly related to the taxpayer's welfare. The popularity of the state income tax has been reduced and its administration weakened because the tax has not been hidden, has not been simple, and has not been closely related to government services.

SUMMARY OF ADMINISTRATIVE PROBLEMS

The first portion of this paper is a summary of the specific administrative problems which have developed during the approximately thirty years of modern state income tax history.

These problems in most cases, however, cannot be considered unique to state income tax administration. Parenthetically, it should be stated that the administrative problems faced in the assessment and collection of the state income tax are no greater and probably are usually less difficult than the problems arising from the assessment and collection of other taxes. The enumeration which follows will highlight the many state income tax administrative problems that at one time were considered nearly insurmountable, but which are now largely eliminated or are well on the way to oblivion. In my opinion, this note of optimism toward state income tax problems is deserving and appropriate.

The administrative problems which I will mention are well known; they have been discussed at numerous tax conferences. In addition, they have been analyzed by special state and federal studies, and the solutions which have been recommended and adopted are in most cases a part of the general knowledge of persons interested in tax matters. It is not my intent at this time to re-examine or even to summarize all the problems and the recommended solutions but rather to merely pause briefly to point up some facets of both.

1. The protection from political pressures of the personnel actually engaged in the administration of the state income taxes.
2. The utilization of other state and local tax data to obtain information for the improvement of the assessment and collection of the state income tax.
3. The utilization of federal income information to improve the collection of the income tax from income obtained by the taxpayer from sources outside the state's jurisdiction.
4. The development of allocation formulae that are just and legal to be used in the determination of taxable income of a corporation engaged in an interstate business.
5. The assessment of the income of the farmer, the professional man, and the small businessman.
6. The problem of keeping the state definition of taxable income approximately the same as the federal.
7. The collection of income taxes from the small-income receiver.
8. The auditing and checking of returns, particularly those of the very large corporations and the small individual income receivers.

9. Double taxation of the income of people working and living in two different states or living and owning property in two different states.
10. Public understanding of the provisions of the state income tax laws. (Even the exclusive readers of the comics are made aware of the federal income tax requirements, but this is not true of the state income tax.)
11. Inadequate budgets and insufficient job protection which have made it difficult for the state departments of taxation to obtain and to keep competent personnel.
12. Finally, the all-important over-all problem of getting nearly all income reported without spending a large quantity of public revenues.

Undoubtedly, other state income tax administrative problems of a deep-seated nature could be mentioned; this listing of twelve, however, meets the purposes of this paper.

An underlying basis of many of the remaining state income tax administrative problems is the lack of an understanding of the importance of adequate public relations. Adequate public relations can increase taxpayer cooperation and the accuracy of returns completed by the taxpayer or an employed tax expert. Adequate public relations can increase the appropriations for the administration of the state income tax law. Good public relations activities can increase the cooperation offered by other tax collection agencies, including even the federal government. Public relations activities can improve the legislative provisions of state corporate and individual income tax laws. Income tax administrators cannot expect public support for their legislative programs unless the facts are continuously and forcefully brought to the public's attention. If the basic principles of good public relations are adopted, the aid which public opinion will give toward the solution to state income tax administrative problems will exceed the most optimistic expectations.

Several years ago, it was frequently stated that the federal invasion of the low-income tax field would be detrimental to the revenues of the states heavily relying upon income within these brackets. This is not the basic situation. The federal government's development of withholding as a tax collection procedure has provided the states with a great administrative aid in the collection of income taxes from low-income recipients.

Every state should take advantage of the opportunity and enact withholding legislation resembling that of the federal government. In this respect, the municipalities in the establishment of their income taxes have been more on their toes than have the states in their income tax law remodeling. Oregon has led the way in adopting this partial but very useful solution to the important administrative problem of efficiently collecting individual income taxes from low-income receivers.

This is an excellent time to mention that the talk about "double taxation" when referring to the federal, the state, and the municipal taxation of the same income is inaccurate and vile propaganda. Not only the income tax but almost every tax is paid from current income; and, if the term is used to include savings, inheritances, and gifts, all taxes are paid from income. The taxation of income does not become undesirable because it is levied by different levels of government, and it cannot be rightfully criticized on this basis. Also, a basic criticism of the use of income taxes by different levels of government cannot rest upon administrative inefficiency. The rapidly developing, increasingly efficient, intergovernmental and departmental cooperation destroys this type of argument even if the logic of the situation were not sufficient. The taxation of the same income by different levels of government can only be successfully criticized on the basis that the income tax itself is undesirable. The income tax might be considered undesirable because the tax payment is not hidden from the taxpayer or because the law is unjust in the types of income taxed or the rates applied, but that is quite different from saying that it is bad because it is administered by several levels of government.

Before beginning an examination of developing and unconsidered income tax administrative problems, let us glance briefly at the administrative problems of collecting income taxes from the corporation.

The 1948 *Report of the Committee on Uniform Income Tax Administration to the National Association of Tax Adminis-*

trators recommends that the income of interstate corporations be allocated to each taxing state by the use of a "three factor formula of Property, Payroll and Sales." [1] The Committee further recommends that this same factor formula be used by all states. I agree with the suggested solution to this chronic problem. To my mind, the recommendation of uniformity is largely desirable not because of the small amount of double taxation of corporate income—which is really largely a tongue in cheek argument—but rather because of the bad publicity it gives the state taxation of corporations. This bad publicity emanates from corporation and federal government sources. This recommendation reverts back to the importance of public relations in tax administration. Part of the success of the opposition to state income taxes stems from effective propaganda use of this particular administrative weakness. It should be promptly and entirely removed.

Developing and Neglected Administrative Problems

There are a number of state income tax administrative problems which are in the developmental stage and, because of this, have not been sufficiently considered. In addition, there are a number of problems that have been neglected despite their importance. A consideration of these developing and neglected problems may seem a good deal like borrowing trouble. This is not the intent. Rather, their analysis is considered an application of the old saying, "A stitch in time saves nine." A discussion now may avoid trouble later through developing proper understanding and taking proper precautionary measures. The order of the appraisal of these problems should not be considered indicative of their relative importance.

State-Local Cooperation

One is the administrative cooperation between the state department of taxation and the local governments levying an income tax.

[1] Mr. A. E. Wegner of the Wisconsin Department of Taxation is chairman.

The income tax is being more and more widely used by local governments. Those cities using the tax find it very helpful in meeting their constantly increasing demands for local revenue. The income tax can be made a much better tax if the state cooperates with these municipalities in their administrative problems. The possibility of using supplements to the state income tax rather than enacting a complete municipal code should be given serious consideration. Also, the states should work for the modification of Section 55 of the federal Code to permit the cities to obtain greater help from the federal government's income data.

State governments should look with favor upon the development of city income taxes and should not block their use through the application of the pre-emption doctrine. It should be possible for the states and the municipalities to pool their income tax administrative resources in a very effective way.

Community Property

Another of these problems includes both the acceptance or the rejection of the community property principle which is now a part of the federal income tax law.

The use of community property in calculating state individual income taxes is not as important as it is in the calculation of federal individual income taxes. For this reason, and because it will reduce the confusion to taxpayers, it would be desirable if all states also collected their individual income taxes on the community property basis. Also, the use of community property reduces the administrative problems arising from family partnerships. Tax difficulties arising from family partnerships tend to reduce public respect toward the income tax. It is bad public relations.

Combining Spendings and Income Tax

A third problem is the desirability of combining a spendings tax with the income tax.

A number of states already have both a general sales tax and

an individual income tax, and the likelihood is that their number will increase. The administrative steps in the assessment and collection of the general sales tax and the individual income tax are quite different. These tax measures require nearly two complete administrative organizations. This is not the case with a spendings tax and an income tax. The administration of these two taxes is necessarily closely associated. The spendings tax and the income tax could be collected largely as one tax. But this is impossible with the general sales tax and the individual income tax. In addition, the spendings tax could be graduated to make it fit more adequately the requirements of fiscal policy. Undoubtedly, the collection of both general sales tax and an individual income tax results in an inefficient use of tax administrative resources.

Taxpayer Awareness of Income Tax

A fourth problem is the taxpayer awareness of the individual income tax.

The individual income tax should be administered so that the typical taxpayer is not required to make large payments. The payment of the tax should also be made as automatic as possible. The income tax, in my opinion, is a much better tax than the general sales tax or the tobacco tax; but it is apt to lose at the polls because each payment is relatively large and the payment is not made automatically as the income is received.

A step toward the elimination of this administrative problem is the adoption of withholding at the source of income. Withholding need not apply only to wages but can also be made from the payment of dividends and the payments to farmers for products sold.

Personal Exemptions

A fifth problem is that of personal exemptions. These should be simplified and made an amount of tax rather than an amount of income.

A complicated individual income tax schedule of personal deductions increases the cost of auditing, the possibilities of tax evasion, and, worst of all, taxpayer annoyance. A short form similar to that used by the federal government for low-income receivers should be available to all payers of state individual income taxes. The deductions, however, should be an amount of tax rather than of income. This method of making deductions avoids injustice and increases collections from the higher-income receivers without increasing the rates. Both of these effects—the elimination of injustice and the low apparent rates—are administrative advantages. Because of the increased number of returns which can be checked with a given appropriation, important administrative desirability is associated with reduced auditing costs per return. In addition, the reduction of taxpayer annoyance increases the popularity of the tax which reduces many administrative problems.

Basis for Taxing Business

A sixth problem is that of taxing business on the basis of size and of type of activity rather than method of organization.

The taxation of business income has encountered avoidable problems because of the unhappy selection of corporate organization as the basis for liability to taxes on business income. This basis has appeared unjust and has increased the problems of business taxation. However, the taxation of business income is desirable because of its administrative ease and because it is a method by which the general public can share in the returns arising from monopoly and exploitation of natural resources. Also, the taxation of this type of income is partially hidden. These aims have not been efficiently accomplished by placing an additional tax burden upon all corporations. Rather, corporations, partnerships, cooperatives, and individual proprietorships should be subject to different tax rates upon net income depending upon the type of activity in which they are engaged and the portion of the total activity of a particular type within a certain geographical area they control.

Business taxes levied upon this basis would make much better sense to the general public and would gain its support. As a result, they would be much easier to administer. Also, the continuous income tax administrative difficulties arising from changing the method of organizing business activity would be removed.

In addition, the basis for continuous propaganda attacks that cooperatives are not paying as great taxes as corporations would be removed. Business taxes would be based upon type of activity rather than upon type of organization. This change would greatly increase the fiscal desirability of business taxes, and it would indirectly bring about improved tax laws aimed at the taxation of business income. The windfall gain would arise because the legislatures would feel that the incidence and the effects of the levy could be determined in a much more accurate fashion. The tax upon income of business would not only be a method of obtaining revenues but would also be accomplishing desirable social purposes that the rank and file of the voters support.

If the above reform is too drastic for immediate adoption, and I am afraid that that is the prevailing situation today, it might be possible to separate the giant interstate corporations from the small corporations employing only a few hundred persons and a few hundred thousand dollars of capital. The giant corporation and the small corporation are similar only in that both bear the name corporation. In all important respects, they function entirely differently. If this dissimilarity were recognized in tax legislation, many of the difficulties arising from demands for graduated rates and the application of graduated rates to corporate income would be eliminated. Also, this would be a step toward making business income taxes purposeful.[2]

Tax administrators generally report that business income taxes are easier to collect than are individual income taxes.

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[2] For a complete discussion of the forces causing the development of the present type of business income taxes in the United States, see my book titled *The Corporate Franchise as a Basis of Taxation,* Austin: University of Texas Press, 1944.

This administrative advantage is real, and it is also important. Taxes on business income are perhaps as just as taxes upon individual income, and they should not be reduced because of some very inadequate evidence of their incidence gathered during the war and postwar boom. Everything possible should be done to reduce the cost and the inconvenience of tax collection. The expansion rather than the contraction of business income taxes would be advancing in this direction. Studies now under way and completed, aimed at determining the effects of taxes upon particular firms and industries, will aid legislators in attempts to levy business taxes that are politically acceptable and economically desirable.[3]

[3] For example, see *Public Finance of Air Transportation*, Columbus: Ohio State University, Bureau of Business Research, 1948, by Richard W. Lindholm.

CHAPTER XXXIV

STANDARDS FOR APPRAISING WORK OF INCOME TAX AUDITORS

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WHEN OUR Director of Research and Statistics first heard of the subject I am to discuss, he remarked that the standards for appraising work of income tax auditors were about as elusive as a black cat in a dark alley. I was happy to learn that someone else thought the subject a little vague and hard to define. I hope, however, that this is not the impression that I leave with you.

BASIC ASSUMPTIONS

Before endeavoring to enumerate these elusive standards, I would like to point out certain basic assumptions which can be made. Those charged with administering income tax will do everything possible to have a just and fair administration. The citizens of the state should be conscious of the fact that their tax administration is just and fair, and that there is no discrimination. Collection of income tax should be on the basis of what you owe, not whom you know.

A second assumption is that the income tax administrators will do everything possible to obtain compliance so that the burden will fall equally upon all persons who should pay the tax. The taxpayer's morale in the state can probably be raised more quickly by constant reminders that every possible effort is being made to secure payment of income tax from all who owe than it can by any other means. Prosecution of a few

criminal fraud cases is one of the surest ways of obtaining wide publicity and a consequent sudden increase in compliance. Many other methods can be used. Among these are obtaining information returns from all employers, obtaining federal abstracts of all changes made in federal tax liability, photostating all federal returns filed by citizens of your state every third or fourth year, keeping field men alert for all possible tax evaders, and coordinating information the Department of Revenue receives concerning the various other taxes it administers.

The Joint Committee on Internal Revenue Taxation in the Eightieth Congress gave much consideration to compliance or enforcement of income tax laws. In this report the committee said:

> Enforcement is necessary not only to preserve an equitable balance between honest and dishonest taxpayers but also between those with simple and those with complicated returns, between those to whom the taxing statute may be applied with ease and those to whom its application is difficult, and between those who are careless and those who are meticulous in keeping their supporting records.

We have assumed that the administration of income tax will be fair and just and that good compliance will or can be obtained. Let us now determine what standards should guide us in our appraisal of the work done by our income tax auditing section.

The income tax supervisor may or may not be considered an auditor, but the ultimate success of the entire auditing section depends in great part on his proper selection of the work to be done. Also, the auditor himself must select which work is important enough to spend more than the normal amount of time on when a special problem arises. Indeed, selection is such an important factor that I am considering it our first standard.

Methods of Selecting Returns

There are three basically different methods of selecting returns for audit. The first is to audit predetermined classes of taxpayers, such as all persons who have been assessed additional

tax by the federal government, all persons with large incomes, or all persons who meet any number of other prescribed characteristics. The second method is to have trained personnel screen all returns in a brief survey and select those warranting further audit. The third method is random sampling. Effective selection will enable the supervisor to use the personnel available most efficiently. No one who has studied state income tax administration need be reminded that it would be virtually impossible to employ sufficient personnel to attain perfection. Therefore, the administration should endeavor to attain a proper balance in the selection of the returns to be audited.

The main result achieved by good selection is the accomplishment of the major objectives of income tax administration at the expense of the details normally attached thereto. The auditor himself aids materially in this matter by deciding whether the problem presented is important enough to carry on through to the bitter end no matter how difficult it is and how much time is necessary, or whether the amount of tax is so small and the principle involved so inconsequential that no more time should be wasted on the particular problem. Therefore, our standard of selection appraises the collective work of our income tax auditing section by a consideration of how well both the supervisor and the individual auditor select the returns to be audited and the amount of time to be spent on each audit.

Measuring Quantity of Work

When the work of the auditors is properly selected, the next consideration, and our second standard, is the quantity of the work they are doing. This quantity should be measured by the number of audits made per auditor and the amount of additional tax assessed per audit. I mention both at the same time because a consideration of one without the other might give a distorted picture. For instance, if an auditor were completing a large number of audits without assessing the normal amount of additional tax improper selection would be indicated.

The most simple method of measuring the actual work done by office auditors is to have them keep monthly reports entering the number of audits made, the additional tax found due, the refunds made, and the general sources from which they have obtained the returns which they have audited. A clerk can then compile this information into monthly and annual reports which can be compared with work done during other periods.

To appraise the quantity of work done by a field auditor according to some prescribed standard is more difficult. Perhaps the best measurement of quantity is the amount of additional tax assessed. I hesitate to suggest this as a measurement, however, because a constant endeavor by a field auditor to make an additional assessment may well prevent him from seeing the merits of the taxpayer's contentions.

Measuring Quality of Work

The third standard for appraising the work of income tax auditors is the quality of their work. Emphasis should be on the proper determination of the tax liability whether it means revenue to the government or a refund to the taxpayer. Quality is the result of proper supervision and training and is attained because the auditors are accurate in their decisions concerning the accounting and legal problems which are involved in most tax cases. Quality is attained because all classes of taxpayers are treated in an equal manner and all taxpayers are treated individually.

The standards which we have set out for appraising the work of income tax auditors are achieved because the auditors have the ability to properly perform their work. It becomes necessary for us to consider what the work consists of so that we can determine whether or not our standards will be reached.

Standards for Office Auditors

There are two distinct groups of income tax auditors—the office and the field auditors. The office auditor spends most of

his time at a desk assessing additional tax, authorizing refunds, or generally adjusting reports of thousands of taxpayers whom he has never met. His source of information is the income tax return and any information which he can obtain from correspondence with the taxpayer. On the other hand, the field auditor spends most of his time interviewing taxpayers and going over their books in the taxpayers' offices. It is evident that a standard for one auditor is not the proper standard for the other.

First, let us look at the office auditor and determine why he does or does not meet the standards which we have set out. After clerks have checked all returns filed for mathematical accuracy, certain returns will be selected for audit on the bases previously described. The office auditor works with the facts and figures presented on the income tax return and with other supporting information that is supplied to the department. Although his sources are limited he may apply various auditing devices to determine the authenticity and correctness of the return. His other duties may consist of interviewing taxpayers and their representatives, arranging informal conferences with them to explain tax laws, regulations, and decisions affecting their cases, and giving technical advice on various accounting problems.

The standards for appraising work of income tax auditors are also attained in part because of the ability of the auditor to distinguish accounting problems from legal problems. Many of the problems presented to the auditor contain both legal and accounting difficulties, and erroneous results would be obtained if either were considered to the exclusion of the other. Actually in many cases it is necessary to arrive at the proper accounting procedure or solution and then to determine which legal principle will decide the problem on the basis of the proper accounting technique. As few auditors have studied tax law extensively, and most of them would not be qualified to decide difficult legal questions, it is sufficient for them to point out in complicated cases that there is a legal question

involved and to give their opinion as to what the correct solution to the accounting problem is.

Since the initial decision regarding an additional assessment or refund rests with the auditor, he may be aided to a material extent by his ability to use the various reference sources at his command. The auditor should naturally have a good understanding of law and must refer on numerous occasions to the Commerce Clearing House Tax Reports and Prentice-Hall Tax Service. With the use of these current publications he may make decisions on certain special and technical problems which he would otherwise have to pass on to the supervisor. Every auditor should become thoroughly familiar with these references and make full use of them.

Our standards are attained in part because of the auditor's ability to express his ideas concisely in correspondence. The auditor will send a bill, a form letter, or a letter to almost every taxpayer whose return he reviews if his work is properly selected. When a letter must be written, it should be concise and clear. The auditor should explain what information is desired or what disposition is being made in as few words as possible and in language so simple that there can be no misunderstanding, and consequently further correspondence concerning the matter involved.

Often an answer from the taxpayer will bring out some unexpected information which opens further fields of investigation. Then the ability of the auditor to follow up the case becomes important. The "best" office auditor may well be the one who can successfully follow up and complete the greatest number of audits and assess the largest amount of additional tax without irritating a taxpayer or endeavoring to collect taxes not due the state.

One of the most important things the office auditor must learn is when a problem should be referred to the supervisor. The auditor must be able to recognize, or in some cases to anticipate, the seriousness and the far-reaching effect of the problem involved in the particular audit. The auditor should

be able to obtain most of the facts. These should be given to the supervisor with a statement of the difficulties which have either already arisen or which are to be anticipated in the near future. Knowing when to turn this work over to the supervisor will mean that there will be no duplication of work and that the income tax administration will seem to the taxpayer to be well organized.

Standards for Field Auditors

Let us now turn our attention to the field auditor and endeavor to determine why he does or does not meet the standards which we have set out for him. One of our main observations is that the field auditor should have a more diversified training than that usually acquired by the office auditor because he deals directly with the taxpayer auditing the accounting books and records of individuals, partnerships, corporations, and trusts to determine the correct state income tax liability. He prepares detailed reports of findings and submits supporting exhibits and he investigates the methods of apportioning income to the state and the factors giving rise to this apportionment. Also, a field auditor should spend a number of months as an office auditor before being sent to the field.

It is possible for the field auditor to attain our standards because of his ability to use initiative in whatever work he has been assigned. The supervisor who assigns the work usually knows only generally what the field auditor should discover by his examination, and the field auditor will normally discover a number of unusual circumstances, some of which he should investigate immediately, others of which bear no need for investigation. He should be able to distinguish between these without reporting to his home office for instructions.

Often the most difficult problem which the field auditor faces is determination of various questions of fact. It is almost impossible to set out any guide that will aid the field auditor in determining the true facts of the particular case, but it is always

well to treat all statements made by the taxpayer as being true until something shows that the trust has been misplaced.

In most states where the field forces are inadequate the use of the various reports of the Bureau of Internal Revenue may supplement their work and aid in the administration of the state income tax law. It should be remembered, however, that the findings of this agency are not necessarily conclusive. For instance, civil fraud might be assessed on a rather arbitrary basis to open back years for assessment. The state, in order to administer the tax properly, should not necessarily base its assessment of fraud solely on these federal findings, but should draw its own conclusion from the facts involved in each case.

When the auditor is investigating a taxpayer before the federal agents have made their investigation, the auditor must make his own determination of whether or not there is either civil or criminal fraud, and, if so, the auditor must then collect all the data and information necessary to support his charges. In cases where he suspects criminal fraud, he should ask for the assistance of the department's legal section to find out what kind and how much evidence is needed in the particular case for the prosecution.

Of course, the efficiency of both the office and field auditor may be increased by coordinating the sources of information available to each. Time and correspondence may be saved by a complete presentation of all information when any matter is being sent from the home office to the field, or from the field to the home office.

Personal Qualifications of Auditors

We have covered many of the reasons why both office and field auditors attain the standards we have chosen for appraising their work. Now, let us stop for a moment and look at the personal qualifications of the auditor who will be able to meet these standards.

This auditor should be a graduate of the commerce college of a well-recognized university or business school. He should

have majored in accounting and have both good grades and a lot of good common sense. He should be able to distinguish between the theoretical and the practical aspects of tax problems.

State salaries are often very low, but then the salaries which C.P.A. firms are able to pay young graduates with no experience are also usually quite small. One or two years of experience from the inside of a tax administration may well be worth several years of outside training. Many good auditors are willing to work for this experience, and the Kentucky income tax auditors are proof that good auditors can be obtained for the experience which we can give them, even though our salary is often less than they could get from certified public accounting firms and much less than they could have obtained from a federal C.A.F. 7 rating.

One important item should not be overlooked by any income tax administration interested in obtaining a force of smart young accountants to do its auditing. Most states have a statute describing the qualifications one must have to sit for the C.P.A. examination. One of the requirements frequently found is that the person must spend two or three years in the employment of a public accountant. If the legislation appropriately provides that time spent as a state income tax auditor will count just as much toward making the person eligible to take the examination, then the state income tax administration should have no trouble in securing excellent accountants providing it offers salaries commensurate with those offered by the certified public accounting firms.

Qualifications of Supervisor

The last major topic which concerns standards for appraising the work of income tax auditors is the type of management these auditors have.

The general supervisor of income taxes should have a background of legal and accounting training. An attorney who is a certified public accountant is the person best qualified from

an educational point of view to administer the income tax laws of a state. As it will be difficult, if not impossible, for any state to secure the services of one so qualified, the supervisor should meet the minimum requirements of a good background in both subjects with emphasis on the legal side because all of his auditors should have excellent training in accounting and have much less need to consult him concerning their accounting problems than their legal problems.

Next the supervisor must be capable of actually supervising the auditors' work. The assignment of their work depends to a great extent upon ultimate planning of the supervisor and his superiors, and a well-planned program will result in better achievement of the standards we have set out for appraisal of income tax auditors' work. The supervisor should always be available to help out when the auditors become stuck with a problem too difficult for them to decide. He should wisely assign the daily work of each auditor, seeing that none of them become stale by doing too much routine work and that the section as a whole is putting out its maximum work. The proper balance must be attained between assignment of work that results in additional tax, assignment of work aimed at getting more complete compliance, and assignment of work whose sole aim is to sell the public the idea that they are getting the best administration that their tax money can buy.

One last thought should be expressed. The best possible standards for appraising the work of income tax auditors are of little or no value to the income tax administration which does not make use of these standards. Once these standards are set out, they should be used to the fullest so that the maximum over-all efficiency of the income tax section as a whole will be obtained.

CHAPTER XXXV

DIFFICULTIES ENCOUNTERED BY INTERSTATE CORPORATIONS IN COMPLYING WITH VARYING STANDARDS OF ADMINISTRATIVE PROCEDURE

Louis Schreiber

E. I. du Pont de Nemours and Company

THE ADMINISTRATIVE PROCEDURE in any income taxing state, whatever its nature, confronts corporate taxpayers within its jurisdiction with more or less serious difficulties. But the interstate corporation has its own special administrative problems because it is compelled to face the administrative procedures of several or many states, no two of which are quite alike. It is these problems with which, I understand, I am expected to deal. In so doing, I shall pay scant attention to the word "standards." To my mind, there are no standards in state tax administration, and I presume that my topic was not worded on the assumption that there are. Administrative procedures simply differ. Some I might classify as good, others as bad; some are rather formal, others essentially informal; etc. But even if they were all good, so long as they were different, the interstate company would have its special difficulties.

Internal Difficulties Encountered

Broadly speaking, the difficulties encountered by an interstate corporation which are solely attributable to the fact that administrative procedures do vary may be divided into two categories: first, those which are internal to the company, and

second, those which the company meets in dealing with the taxing authorities of the several states to which it is liable for tax.

Keeping Up With State Laws

One of the internal problems is the very necessity of becoming familiar with, and keeping abreast of, the procedures followed in a number of states—in our case, all of the states imposing the income tax. This means that the tax department of such a company must either spread itself so thinly in handling its state income tax problems as to lose effectiveness, or its personnel must be enlarged far beyond the point that would be necessary if the administrative procedures in the various states were essentially similar. I cannot give any actual figures, but I am sure that the very considerable expense incurred by my company in the unproductive work of determining how much we owe in taxes would be appreciably reduced if such administrative procedures were more nearly uniform. No doubt every other large interstate company which attempts to handle its tax problems adequately and intelligently would agree.

Procedural Requirements

Moreover, even if the company has an adequate staff, it is still very easy to slip up on some procedural requirement in a particular state, especially when there are matters pending in several states at one and the same time, as is frequently the case with us. There are such things as statutes of limitations, prescribed periods for filing protests or refund claims, and the like, where we occasionally go astray when a host of problems are demanding attention. Not long ago we had such an experience in connection with a protest. In most cases, a protest properly filed may be taken up in conference or hearing at any mutually convenient time in the future. Some statutes provide, however, that action by the administrative authorities must be taken within a specified period, while others provide that if no action is taken within a set period, the protest shall

be deemed to have been denied. Expiration of the period automatically starts the running of the time prescribed for taking an appeal. In the instance of which I speak, our tickler system went astray, and we lost an opportunity for hearing before the primary administrative agency.

Preparation of Returns

In the preparation of our state income tax returns, we are compelled to devote many man-hours that would be unnecessary if administrative procedures were more uniform. In such preparation, we use a worksheet upon which we list each item entering into the computation of net income for federal tax purposes, i.e., interest, rents, royalties, dividends, depreciation, taxes, etc. This starting point is used for each return, and accordingly a number of such sheets are prepared in advance. In the preparation of the return for a given state, adjustments must be made to the federal return figures, in accordance with the requirements of the state law and regulations, and administrative rulings. This requires very careful analysis in the case of each state return, and therefore a great deal of time, much of which is attributable to purely administrative differences.

Examination of Returns

Then, there is a matter of examination of returns. Not all the states send agents around to make an audit, but a number of them do, and in each case there is sufficient variation in the approach followed and the detail demanded as to require us to do much of the same work over and over. It is our feeling that the same set of work papers could be made to serve most of the purposes of the auditors for the several states, if each of them did not insist upon his own particular method. But for that, we could save a lot of time and effort, not only for ourselves but also for the auditors, and our tax liabilities would be settled a lot earlier. One of our minor annoyances in this connection is the habit of some auditors of walking in on us unannounced, ready to go to work—just as like as not at the

same time a crew of federal agents are on the job, taking up most of the time of our tax accountants.

Problems Arising from Varying Administrative Applications

So much for the internal problems attributable to varying state administrative procedures. While they entail considerable cost, perhaps they should not be regarded as of great importance; in themselves they are hardly sufficiently serious to justify any strong plea for greater uniformity. But let's look at the other class of problems, those which the interstate company meets because of varying administrative applications or approaches to the same item of income or expense, or to the same transaction, or to the same factor in an apportionment formula. It is this type of problem that is most serious for the interstate company, that requires the expenditure of much time and money, that frequently leaves the taxpayer with a feeling of injustice and a wish that a greater degree of uniformity could be achieved.

Deduction for Federal Income Taxes

For example, one such problem we have met relates to the deduction for federal income taxes, which many of the states allow in computing income taxable by the state. For the interstate corporation the proper method of determining the amount of the deduction is frequently a headache. This is occasioned by the fact that some state laws do not specify the method, and it is left to the tax administrator. The easiest way to determine such amount would be simply to apply the federal tax rate (38 per cent for the larger corporations) to the income apportioned or allocated to the state. But some authorities prescribe rather elaborate methods. In some states, the amount of the deduction is determined by ascertaining the ratio of federal tax to federal net income and applying that ratio to the income assigned to the state, but in arriving at such ratio, no adjustment is permitted on account of dividend income which

is included in federal net income but is not assigned to the state. Obviously, the effective federal rate on dividends is 5.7 per cent and without proper adjustment therefor, the federal tax deduction is unfairly reduced. Then, some authorities require that the federal tax deduction be split and allocated against apportionable income and nonapportionable income, both within and without the state. With the advent of the federal excess profits tax, a few years back, this problem was considerably magnified. In my view, there is little excuse for these vagaries in the handling of what is essentially a simple matter.

Treatment of Special Items Not Subject to Apportionment

We also have run into difficulty with respect to the treatment of special items of income which are not logically subject to apportionment. For example, we have had in the past a rather sizable amount of income in the form of a service fee for operating a plant belonging to another company, which bore all the costs of production and which marketed the product under its own name. What we got was, in effect, the equivalent of a salary. Obviously, the entire amount of this fee was earned within the state in which the plant was located; certainly none of it was earned in any other state. Obviously, also, the state where we earned the fee insisted on taxing it in its entirety. In most of the other states in which we do business, we had no difficulty with respect to this item; the administrative officials there readily agreed that it would be unfair and improper to assign any part of this income to their own states. But several states wanted to apportion this item along with the net income derived from our own manufacturing and selling activities. In fact, some of these states were even disinclined to recognize that the inclusion of this fee with other income would at least require some fair adjustment in the apportionment factors. Eventually, the matter was satisfactorily settled in all cases, but a lot of unnecessary time and effort was expended in the process.

Similarly, we find considerable variations among the states with respect to the treatment of such items as royalties and interest income. Because of differences in administrative approach, it is sometimes difficult for us to persuade the tax official that such items should be excluded from apportionable income where, as in our case, they are wholly unrelated to the kind of business we conduct in his state.

Application of Allocation Formula

But by far the most serious problem that the interstate company meets under varying administrative procedures, and perhaps the only one really worth discussion, relates to the application of the allocation or apportionment formulas which are used to determine the net income taxable in the particular state. Every interstate company is, of course, vitally interested in having allocated to a particular state for taxation no more than a fair portion of its total net income. We believe, even in these "enlightened" days when taxation is supposed to have more important objectives than merely raising revenues, when many people appear to believe that the objective of equity is quite subservient to social and other purposes, that the same segment of our net income should not be taxed by more than one state, and that the income from a related series of operations and transactions which take place in several states cannot be properly divided up into a number of parts which together exceed the whole.

I have no desire here to go into this troublesome matter of apportionment in all its phases; in any case, I doubt that I could add anything to the voluminous literature on this subject. But, of course, it is the interstate company that suffers from the imperfections and inconsistencies inherent in these apportionment formulas. Let me take a rather unusual, but by no means fictitious, case. We manufacture a certain article in Virginia; we warehouse it in New York. It is sold to a customer in Tennessee through a sales office in Pennsylvania. Virginia uses a formula composed of two factors, property and

sales, and since the property used in producing the article and the sale itself are assigned to that state, it, theoretically at least, taxes 100 per cent of the income. But New York also reaches the income because it includes in the numerators of its apportionment formula not only the sale but also the value of the warehouse, which we own, and the compensation paid to the employees at the warehouse. Pennsylvania not only assigns the sale to itself but also the salaries of the personnel in the Pennsylvania sales office. Tennessee has to be satisfied with merely assigning the sale to itself. Thus, each of the four states assigns the same sale to itself, while in three of them one or more additional factors are used to apportion part of the income from the transaction. Of course, no one can say exactly how much income is actually taxed by each of the four states as a result of this transaction. The actual effects of any apportionment method cannot be accurately measured with respect to specific transactions, but it would appear to be obvious that considerably more than 100 per cent of the income from the sale described is taxed by the four states.

Any apportionment formula is arbitrary and must by its very nature work against the taxpayer in some cases and in its favor in others. All we can hope is that the pluses and minuses come near to cancelling out, but certainly the chances of such cancelling out are not very bright when sales allocation in one state is on a by, through, or from basis; when in another state, it is based on intrastate sales plus interstate sales *terminating* therein; when still in another state, it is intrastate sales plus interstate sales *originating* in the state; and when in another state, it is intrastate sales plus half the interstate sales originating *or* terminating in the state. In fact, one state once attempted to include all intrastate sales and all interstate sales until it was slapped down by its own courts.

Now, this inconsistency of treatment occurs not only because of differences in statutory apportionment provisions, but also because of differences in administering or applying the same formulas, and particularly in the computation of the sales

factor, even where that factor is expressed in the same language. For example, in a number of states the law provides that sales shall be allocated on a by, through, or from basis—that is, sales shall be allocated to the particular state when they are made by, through, or from a sales office located *within* the state. But that isn't always the way the law is administered in those states. In one such state we have sales offices for two of the departments of our company. Our other departments do not have sales offices there, but some of them have stock points, such as public warehouses, from which goods are shipped pursuant to sales negotiated wholly without the state. Other departments simply send salesmen into the state and take orders which are filled from without the state. Some follow a combination of these methods. Are sales allocated to that state confined to the business done by or through the sales offices we have there, as is apparently called for by the statute? Not if the examiners can help it. They take each of our departments separately and assign to the state either the total deliveries in the state by that department, or the sales made through its office in the state, if any, whichever figure is the higher. Then they add up these higher amounts, to arrive at the numerator of the sales fraction. Of course, a large part of the sales so allocated are negotiated wholly outside the state, and are therefore also allocated to one or more *other* states. But those facts do not apparently bother the examiners I have in mind, despite a provision in their regulations that sales negotiated at a place of business outside the state shall be allocated outside.

Refusal to Allow Company Tax Official to Present Case

Mention may be made of another variation in administrative procedure which sometimes hits the interstate company. This occurs in some of those states which have set up a reviewing body, sometimes known as the Board of Tax Appeals. Where such a Board is organized and functions as the equivalent of a court, it may deny representation before it, on behalf of a taxpayer, by any one who is not a member of the state bar

or a licensed public accountant of that state. Even where that qualification is not demanded, the Board may require a rigid adherence to the rules of evidence and procedure prescribed by the courts of the state. In either case, the tax man of an interstate company, whose office is in another state, cannot himself handle a matter for his company before the Board but must engage a local attorney or accountant. With all due respect to such local talent, I feel that as long as the matter is still in the administrative stage, the company tax man's knowledge of his company's business enables him to present his case more adequately than can the local attorney. Usually, he has to prepare the case himself anyway, and the necessity of employing outside counsel only causes additional expense. Of course, if the matter goes beyond the administrative stage into the courts and the primary question is one of law, then he may need and welcome any assistance that can be provided by attorneys familiar with the law and the proper legal procedure.

I doubt that I have adequately covered all the difficulties caused interstate companies by variations in state income tax administration, either qualitatively or quantitatively. I have simply distilled my own company's experience, and it is altogether likely that other interstate companies, particularly those in different lines of business, could cite additional and perhaps more serious problems. I hope, however, I have made it clear that these difficulties cannot be lightly disregarded. They may not be quite as great as the difficulties with the administrative procedure of a particular state which are met by all corporate taxpayers, whether interstate or intrastate in character. But they surely deserve sympathetic consideration, and amply justify the efforts of those who are trying to achieve a substantially greater degree of uniformity not only in the form of state income tax laws but also in the procedures by which they are administered.

CHAPTER XXXVI

PROGRESS TOWARD ACHIEVING UNIFORMITY IN STATE INCOME TAX ADMINISTRATION

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THE SUBJECT MATTER of this paper could be disposed of very briefly by merely noting the sorry fact that there has been little progress toward achieving uniformity in state income tax administration. This is so despite the existence of both federal and state income taxes for some thirty years and despite real efforts to achieve some kind of uniformity, or even coordination or cooperation.

CORPORATION INCOME TAXES

A brief examination in the field of corporation income taxes reveals an amazing lack of uniformity, although the federal government adopted a corporation income tax in 1913 and thirty-three states and the District of Columbia have either a franchise tax measured by net income or an income tax on corporations.

Federal-State Uniformity in Measurement of Corporate Income

In 1917, New York pioneered in the "uniformity" field when it imposed the franchise tax on business corporations (Article 9-A, Tax Law). The law then provided that the tax should be based on the "entire net income . . . as returned to the United States Treasury Department." In 1918 the tax was measured by "income which was presumably the same as in-

come upon which such corporation was required to pay tax to the United States." The "presumably" idea was continued in new Article 9-A which was enacted in 1944. Commencing in 1919, however, this general declaration of uniformity began to be cut down. In that year no deductions were allowed for federal income taxes or for losses sustained in other years. In 1920, corporations not organized in the United States were required to pay taxes on their "true" net income rather than on the amounts reported for federal tax purposes. In 1924, interest from federal, state, and municipal bonds and all dividends received from stocks were included in income, and the deduction for taxes paid foreign countries as well as any specific exemption allowed by any other taxing authority were disallowed. In 1931, the deduction for items or sums excluded from gross income by any other taxing authority was disallowed. Since 1935 interest on indebtedness to stockholders has not been allowed as a deduction and this difference from the federal law has been expanded from time to time. In 1941, the disallowance of losses in other years was restricted to net operating losses, "whether deducted by the government of the United States or not." In 1944, other differences from the federal law were provided, e.g., income, gains and losses from subsidiary capital, and 50 per cent of dividends were excluded from entire net income. Hence, despite the initial almost complete tie-up with the federal law, New York in the last thirty years has gradually receded from that position.

Of the thirty-two other states that have corporation income taxes, or franchise taxes measured by income, only six tie in to any extent with the federal law. These are Connecticut, Massachusetts, Pennsylvania, Rhode Island, Tennessee, and Vermont.

Although Idaho and Kentucky have not adopted the federal definition of income, their statutes do provide for the application of the federal rules, regulations, and decisions, where there is no difference existing between the two laws; Idaho applying such rules, regulations, and decisions existing at the time the

Idaho Income Tax Law was first adopted, and Kentucky applying the current federal rules and decisions.

No state ties in to the federal law completely. Each has one or more differences from federal net income such as adjustments for interest, capital loss carry-overs and carry-backs, net operating losses for other years, and interest on obligations of the United States. In substance, in over some thirty years only seven states have taken definite steps toward uniformity with the highly developed concept of federal net income.

Uniformity of State Laws

I must also report an equal lack of progress in so far as uniformity of state laws is concerned. As an example, consider the important problem of allocation of income. Since 1916, strenuous efforts have been made to achieve some uniform method of allocating income within and without the state for purposes of corporation and personal income taxes. The National Tax Association, for example, has appointed numerous committees. As a result of a committee appointed in 1916, a model bill for the taxation of personal and business income recommended the apportionment of net income on the basis of tangible property and gross receipts, property being weighted two-thirds and receipts one-third. Again in 1920 and 1921 committees were appointed to deal with the same problem. In 1922 the Committee on the Apportionment between States of Taxes on Mercantile and Manufacturing Businesses proposed a plan of allocation based on the two factors of tangible property and business, each to be weighted 50 per cent, the business factor consisting of purchases, payrolls, and receipts from sales.[1] In 1925 a new committee of the National Tax Association was appointed which reported in 1926, 1927, and 1928, and finally in 1929.[2] This committee did not recommend any particular formula but suggested a survey, as a result of which the Committee on Uniformity and Reciprocity was appointed in 1929.

[1] *Proceedings of the . . . . National Tax Association,* 1922, p. 198.
[2] *Ibid.,* 1929, pp. 155-59.

In 1931 this committee presented a report on the problem of allocating income,[3] and in 1933 recommended adoption of the three-factor formula of property, receipts, and payrolls.[4] In 1938 and 1939 the Committee on Allocation of Income made reports.[5] That committee concluded that uniformity would be most readily attained by the use of the three factors of tangible property, payroll, and sales. As a result of the efforts of the National Tax Association and other organizations, six states [6] have adopted the uniform formula since 1939, so that now approximately sixteen states [7] out of thirty-three states and the District of Columbia do employ the three-factor formula of property, receipts, and payrolls. However, adoption of this formula itself has not really achieved uniformity. There are still considerable variations in the treatment of each factor by the various states. Various problems arise in the allocation of property. One of these is the allocation of goods in transit. There are also disputes as to where payrolls are to be allocated. However, the principal differences are in the approach to the allocation of sales. Is a sale to be allocated to the state to which payment is made, to the state from which the goods are shipped, to the state from which the salesman making the sale functions, to the state where the order is accepted, or to the state from which billing is made? Even where the uniform formula is in effect all of these various methods of allocating sales may be employed with the result that a sale may conceivably be allocated to six states or, on the other hand, may be allocated to no state. Thus, while there has been some advance in the uniform allocation of income for state tax purposes, progress has been almost at a snail's pace.

Even in a field where it would be assumed that uniformity would be fairly simple, the results have not been too encourag-

[3] *Ibid.*, 1931, p. 301.
[4] *Ibid.*, 1933, pp. 262-64.
[5] *Ibid.*, 1938, p. 486; 1939, p. 190.
[6] Minnesota, New Jersey, New York, Oklahoma, Rhode Island, Vermont.
[7] California, Connecticut, Georgia, Idaho, Louisiana, Massachusetts, Minnesota, Montana, New Jersey, New York, Oklahoma, Oregon, Pennsylvania, Rhode Island, Utah, Vermont.

ing. The problem of allocating the income of an infant industry was made graphic by the decision of the Supreme Court of the United States in 1944 in *Northwest Airlines* v. *Minnesota*, (322 U.S. 292). Under that decision, the domicile of the airline, each state with which the airline had any contact, as well as each state over which its planes fly, has the power to tax. After Congress had directed the Civil Aeronautics Board to explore the field, that Board recommended a Congressional statute which would specify methods of apportioning the several tax bases used by the states. As a result, state tax administrators endeavored to avoid a Congressional mandate by developing a uniform system of taxing airlines. The National Association of Tax Administrators recognized the inequity of multiple state taxation and suggested a model state bill. It was recognized that the states had to adopt a uniform apportionment formula or run the risk of having one imposed by the Congress. The method of allocation suggested by that Association was one that was in accord with the convenience of the airlines. A model bill was prepared in 1946 and was approved by the Eighth General Assembly of the States in January, 1947.[8] Although the model bill has been available to the states for almost three years, only one state [9] has enacted it into law and three others have adopted it by administrative edict.[10] Despite the real threat of Congressional action and the fact that there were few hindering precedents to overcome, the states have not been able to act in a united manner, even in this limited field.

State-Local Uniformity

Brief mention must also be made of uniformity in states where local taxing powers have been granted to cities and counties. The need for uniformity of administration in that field is particularly real. The experience of the state of New York has been somewhat more fortunate than that of some

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[8] *Taxes*, (April, 1947), pp. 302-4.
[9] Connecticut.
[10] Oregon, Washington, Wisconsin.

other states. Since 1933, New York City has had the power to impose various local taxes, including a gross receipts tax. In 1947 the New York Legislature authorized the counties and certain cities, other than New York City, to impose specified taxes, among which was a gross receipts tax.

Within the last six months it has been apparent that a serious duplication of taxes occurs where two jurisdictions within the state impose such a tax. If New York City and Monroe County both impose taxes on gross receipts from sales of goods shipped from New York to Monroe County or vice versa, duplication results unless a fair apportionment formula is devised. The law requires the State Tax Commission to provide an apportionment formula to avoid this duplication and such a formula is in the process of preparation. It should be noted in this connection that controls may be used by a state over the taxes of its cities, but there is, in my opinion, no similar power in the federal government with respect to state taxes, unless an interstate shipment results.

Personal Income Taxes

Progress in the field of uniformity with respect to personal income taxes has equally been lacking.

Status of Uniformity in Federal and State Laws

In 1929, Georgia enacted an income tax law which provided that "the net income . . . shall be the same taxable by the United States and the tax payable thereon to the state of Georgia shall be one-third of that payable to the United States." In 1931, Georgia discontinued federal net income as a basis for measuring the state tax, although it did continue an income tax. At the present time only two states make any effort to use federal net income as a base for personal income taxation. The Kentucky statute provides that "computations of income shall be, as nearly as practicable, identical with calculations for federal income tax purposes," but the tie-up with federal net income is somewhat loose. At the present time only Vermont

makes use of federal net income as a base for its personal income tax. Under its statute net income is the same as net income under the Internal Revenue Code, except for the exclusion of income expressly exempted from tax by the state, and capital gains and losses. Deduction for federal income tax is allowed up to $500. Thus, while the tie-up is not complete, Vermont has taken the lead in the field.[11]

Objections to and Advantages of Federal-State Uniformity

Whether the Vermont plan will receive widespread acceptance depends not only on the experience under it but also on the solution of various other problems which are of great importance, particularly in the larger states where personal income taxes are a major source of revenue. These factors include the following:

1. Income from certain federal bonds is included in the computation of federal net income, but the states probably have no power to tax such income.
2. Many states, including New York, impose taxes on income from bonds of other states and their municipalities, but such income probably cannot constitutionally be included in federal net income.
3. Under the federal law a deduction of state income taxes is permitted in computing federal net income, but many states do not allow deductions for its own or other state income taxes.
4. Capital gains and losses are treated entirely differently under federal and state laws.
5. The different basic dates in the federal and state laws present numerous problems, for example, depreciation, cost basis.

In order to solve each of the foregoing differences, it would be necessary for the states either to abandon income from these particular sources or make adjustments to federal net income. With pressure for revenues increasing, the latter solution is the likely one, with the result that complete uniformity would not be achieved.

Various other difficulties also suggest themselves:

1. The state taxation of nonresidents would not be solved, since federal net income has no relation to income earned within a state.

[11] Lasser, "State Income Tax Simplification in Vermont," *National Tax Journal*, I (March, 1948), 62.

2. The state taxation of individuals and partnerships doing business within and without the state would not be solved, since adjustment of items of income and deductions within and without the state would be necessary.

The foregoing technical objections are the major ones that readily occur when consideration is given to the idea of adopting federal net income as a base for a state tax. Other reasons, however, are probably given greater weight in the minds of many. The principal objection of course is "states' rights." That view relies on the inherent, retained, independent taxing powers of the states. In support of that view it is pointed out that the states must either abdicate their independent power, or, if they adopt the federal law verbatim, wait until their legislatures meet to carry over changes made in the federal law since the state legislatures last met, and finally, that state administrators would have less responsibility.

There are many obvious advantages to a state adopting federal net income as a starting point in determining its personal income taxes:

1. From the states' standpoint, there would be great savings in the cost of tax administration and probably increased revenue.
2. From the taxpayers' standpoint, there would be great economies in the preparation of returns.
3. There would be one rather than possibly forty-nine separate bodies of law on the same subject matter, with the consequent avoidance of duplicate litigation.
4. There could be one audit rather than many.
5. Returns would be more complete and correct.

Little Cooperation or Coordination Between States

Not only has there been little uniformity between federal and state net income but there has been little cooperation or coordination between the states in personal income taxation. This is so although there are many equally complicated problems of multiple state taxation of the same income. Several possible fields of uniformity readily suggest themselves. The most common one involves the taxation of the income of an individual residing in one state but engaged in business in

another, who may be required to pay personal income taxes on the income from that business in both states. There is no excess of uniformity in this field. There are two easy solutions. One is for the state of residence to tax income from all sources. The other is for the state of residence and the state of situs only to tax income from sources within the state. But the fact is that many states do tax income of nonresidents.

The states have recognized the evil of multiple taxes in these cases, but instead of agreeing on one solution, have adopted three different cures. Some states have reciprocal statutes allowing credit to nonresidents for taxes paid the state of residence.[12] Other states allow a credit to residents for taxes paid the state of nonresidence.[13] Others allow both a nonresident and resident credit.[14] Various solutions have been suggested. The Committee on Coordination of Federal, State and Local Taxes of the American Bar Association suggested that the question be compromised by each of the two states taking one-half of the tax. The Committee on Multiple Personal Income Taxes of the National Tax Association, as did earlier committees, recommended the adoption of a nonresident credit on a reciprocal basis.[15] However, the states thus far have not been able to agree on any one solution.

Another possible field of uniformity in state income taxation involves the adoption of a uniform definition of "resident." There are approximately six different varieties in use among the states with the result that an individual may be taxed as a resident in more than one state. A uniform definition suggested by the above mentioned Committee on Multiple Personal Income Taxes has not been universally acclaimed.

Reciprocal Exchange of Information

A certain amount of coordination between the states, however, has been achieved by the reciprocal exchange of informa-

[12] Iowa, New York, North Carolina, South Carolina, Vermont.
[13] Alabama, Arkansas, Colorado, Georgia, Kansas, Louisiana, Mississippi.
[14] California, Kentucky, Maryland, Montana, New Mexico, Oregon, Virginia.
[15] *Proceedings of the . . . . National Tax Association,* 1947, p. 308.

tion. Under that plan, nineteen states have agreements with New York under which information is supplied between New York and such states with respect to corporation taxes, and twenty states have similar agreements with respect to the exchange of information concerning personal income taxes. Similarly, arrangements have been made and are in the process of being extended whereby the states receive information from the federal government. Through the efforts of committees of the National Association of Tax Administrators, progress is being made in the reciprocal exchange of information between the states and possibly in joint state audits.

This cursory examination of uniformity, coordination, and cooperation with respect to income taxes is not too encouraging. Having spent a considerable part of the last fifteen years in this field, the results are in fact frustrating. To tax lawyers, tax accountants, and tax executives who deal with this problem daily, I am sure the results are equally discouraging.

Need of Inter-governmental Agency for Collaboration

I am convinced that there will be no progress in uniformity of state income taxation until some agency is created to deal with the problems inherent in existing tax laws.[16] Such an agency would provide for collaboration between federal and state administrators; would act as a central clearing house for research and interstate cooperation; would raise a public apathy to a public interest; and might eventually get to joint returns, joint audits, and possibly even administration of overlapping taxes.

I do believe that unless the federal and state governments cooperate in this field inefficiency in tax administration and unnecessary hardship on taxpayers will be continued. I do not believe such an agency lessens states' rights or that it means a

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[16] A federal-state fiscal authority was first recommended by the report of the Committee on Inter-Governmental Fiscal Relations of the Treasury Department (Sen. Doc. 69, 78th Cong., 1st Sess.). It was again recommended to the National Tax Association in 1946 (*Proceedings of the . . . . National Tax Association,* 1946, p. 277).

subordination of the states to the federal government. I do believe it will make for more efficient tax administration, a saving in governmental cost, and will avoid harassment of taxpayers. Such an organization would operate on the basis of coördination and cooperation. It would have the power to recommend to the federal government and to the states solutions for present conflicts.

I am of the opinion that eventually such an agency will be created but it will require the combined and untiring efforts of governors, legislators, tax administrators, tax lawyers, and tax accountants to achieve this result. More than that it will require an intelligent public opinion. Unless and until some agency is created to do the job, we will continue to have little uniformity in income tax administration.

PART SEVEN

LOCAL INCOME TAX ADMINISTRATION

CHAPTER XXXVII

LOCAL INCOME TAX ADMINISTRATION IN PENNSYLVANIA

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THE INCOME TAX problem in Pennsylvania may be divided into two phases, Philadelphia and the other municipalities; because although similar in many respects, they represent different problems, both in administration and in application. Both income taxes are the product of a pressure on the Legislature from local governments. The first, the Philadelphia income tax, was a depression-born problem whereas the second was brought about by virtue of an inflationary period and increased costs of local government.

During the depression years, most municipalities were faced with problems of declining revenues and the problem of the large metropolitan cities was particularly pressing. Because Pennsylvania municipalities are governed by special state legislation, they came to Harrisburg for help.

In 1932, during a special session of the State Legislature, the city of Philadelphia and the city of Pittsburgh were given powers to impose taxes on privileges, transactions, subjects, occupations, or personal property which are not taxed by the state. While this act, known as the Sterling Act, was permanent for Philadelphia, it remained in effect only until June 1, 1935, for the city of Pittsburgh. Peculiarly, neither of the two cities took advantage of this act prior to 1935. In 1937, Philadelphia imposed an amusement tax, a documentary stamp tax, and a tax on parking lots. Philadelphia also, under this act, imposed a sales tax in 1938 but abandoned it soon after its enactment.

The Philadelphia Income Tax

In November, 1938, the City Council under the authority given to it by the Sterling Act adopted its first income tax ordinance. It provided for a 1½ per cent tax on all income from salaries, wages, commissions, and on the net profit of unincorporated businesses. The flat rate was imposed because of previous decisions of the Pennsylvania Supreme Court holding that all taxes on income must be uniform in compliance with the uniformity clause embodied in the Pennsylvania Constitution. The limitation to the net profit from unincorporated businesses was due to the fact that the Sterling Act prohibited the imposition of a tax on matters on which a tax is imposed by the state. Corporations in Pennsylvania are subject to a state income tax, hence could not be included under the Philadelphia ordinance.

This ordinance, however, did include some credits and exemptions. It provided for a credit of $15 for each taxpayer for making his return. Since the tax was set at 1½ per cent, this had the effect of making the first $1,000 of income tax free. It also exempted domestic servants, farm laborers, and farmers selling their own products. In addition, there was a provision that the amount of taxes paid to the city on the taxpayer's residence, whether paid by the taxpayer or by another, was deductible as a credit from the tax due. This, again, was intended in effect to give residents a deduction not allowable to nonresidents. In a test case before the Supreme Court (*Butcher* v. *Philadelphia,* 333 Pa. 497, 1938), it was ruled that the ordinance was valid but it was decreed that the exemptions mentioned above were contrary to the uniformity tax clause of the state constitution. The court suggested that the city could proceed with the ordinance as written except for the exemptions noted above, or that it could draft a new ordinance. If a new ordinance were to be drafted, the court recommended that it should make provision for the withholding of the tax at its source by the employer. The City Council immediately

repealed this ordinance and the city was left without an income tax. On December 13, 1939, the council passed a new ordinance which became effective on January 1, 1940, imposing a tax at the rate of 1½ per cent on salaries, wages, commissions, or other compensations, on residents of Philadelphia, and on nonresidents for work done or services performed within the city of Philadelphia. The tax was to apply on all earnings after January 1, 1940. The same rate was also applied to the net profits of unincorporated businesses, professions, or other activities conducted by residents of Philadelphia or by nonresidents conducted within Philadelphia. The tax for this group was to apply to profits earned after January 1, 1939.

The first case tested the differential in period covered. The court held that the difference between wages and salaries and net profits represents a fair, reasonable, and sound classification because wages and salaries are usually certain and predictable, whereas income from business and professions do not have these characteristics. Hence, as long as the burden falls equally on the same class of people, there is no violation of the uniformity clause.

A series of cases followed, testing the liability of various taxpayers, largely nonresidents. With one exception, the courts sustained the Philadelphia ordinance. One case dealt with the problem of a New Jersey resident being taxed in Philadelphia. A case brought by railroad employees contended that the tax imposed an undue burden on interstate commerce. State employees contended that the city was without power to tax earnings of state employees and federal employees made the same contention. In each of those cases, the court sustained the Philadelphia ordinance. In a similar case brought by employees of the Philadelphia Navy Yard residing in New Jersey it was contended that the area where the persons were employed was a federal area, having been ceded by the city of Philadelphia and the Commonwealth of Pennsylvania to the United States Government. The court dismissed this contention. The one case in which the Philadelphia ordinance was not sustained involved

the question as to whether gifts or gratuities of a Catholic priest were to be considered earned income. The courts held that they are not considered as earned income and therefore not subject to the city income tax ordinance.

Administrative Rules and Regulations

The income tax ordinance permitted the Receiver of Taxes to promulgate such rules and regulations as were necessary to carry out the ordinance. Among these regulations was a distinction between income from real estate by owners versus managers of property. It was the contention of the taxpayers that this regulation was in violation of the constitution regarding the uniformity of taxes. The court ruled that this differentiation was fair and reasonable since the ordinance taxed only earned income and not unearned income. Earned income, the court held, is where labor, management, or supervision is involved in the production of income while income derived from the ownership of property alone does not fall within this definition.

A test case was also brought before the Philadelphia Common Pleas Court by the Westinghouse Electric Corporation regarding the provision compelling the employer to withhold the city income tax from compensation paid its employees, residents of Philadelphia, but performing services outside of the city limits. The court upheld the city's contention that the employer was subject to this authority of the city because it maintained a business address in Philadelphia which indicated that it was "doing business" in Philadelphia. No appeal was taken from this decision.

Administrative Problems

These various cases have settled the fact that residents of Philadelphia and nonresidents who are earning their income in Philadelphia are subject to this tax and that the employer is to deduct the tax at its source. In the case of state and federal employees, the court held that since these governments are

superior, the city could not impose any obligation on them. Those employees must file a return and pay the tax themselves. However, the city of Philadelphia is receiving the cooperation of both the state and federal governments. The Governor of Pennsylvania directed all state departments, boards, and commissions to furnish the city of Philadelphia with the names and addresses and the compensation paid to employees who are residents of Philadelphia or nonresidents who perform any part or all of their duty in the city. Similarly, a presidential decree, issued annually through the Director of the Bureau of the Budget, directs all federal agencies to cooperate with state and municipal governments and a special section of this document relates to persons employed by the federal government in the city of Philadelphia. Under this order the city is furnished with copies of Form W-2 or lists containing the names and addresses of the employees and the amounts of their earnings.

Self-employed persons are required to file a return and pay the tax in one lump payment or in quarterly installments.

The withholding feature of the Philadelphia income tax preceded the withholding provisions of the federal income tax. The ordinance provided for monthly reportings by the employers, listing the names of persons from whom the tax was withheld. On March 31, 1948, this ordinance was amended to provide for quarterly reporting in order to comply with the federal income tax deduction schedules.

The taxes are collected by the Receiver of Taxes who collects all other city taxes and water rents. It is estimated that the cost of collecting this tax in Philadelphia is less than 2 per cent of the amount collected. The recent amendment provided for less frequent payments and reporting which should reduce the amount of clerical work and may result in a reduction in the cost of the collection of this tax.

The Income Tax in Other Pennsylvania Municipalities

So much for the Philadelphia income tax. Now, I should like to discuss the more recent income tax phases in Pennsyl-

vania local governments. As I said at the outset of my remarks, both income tax programs were brought about by virtue of pressure from local governments for legislative assistance. In the case of Philadelphia, it was the result of a depression problem and in the case of the other municipalities, it was the result of inflationary increased costs.

The city of Pittsburgh for at least two legislative sessions prior to 1947 had asked for power to broaden its tax base. In the 1947 session of the Legislature, a bill was introduced to give Pittsburgh the same powers that were given to the city of Philadelphia under the Sterling Act. At the same time, other cities in Pennsylvania were clamoring for additional taxing powers, and the school districts, faced with mandatory increases in teachers' salaries, were seeking additional state subsidies. The Legislature, therefore, instead of imposing additional state taxes to give more aid to its school districts and municipalities, decided to delegate the power to local governments to impose taxes on items not taxed by the state. This power was extended to all school districts with the exception of the Philadelphia and Pittsburgh school districts, because their boards are not elected and therefore could not be given such broad powers. Included are all cities, boroughs, and first-class townships. The only governmental subdivisions not included are the counties, institution districts, second-class townships, and the school districts of Philadelphia and Pittsburgh. Altogether, there are 1,037 municipalities and 2,616 school districts eligible to impose taxes under this broad act. As of December 1, 1948, 198 municipalities and 472 school districts imposed various types of taxes under this act of which 140, including 103 school districts and 37 municipalities, are levying income taxes, ranging in rates from 1/5 of 1 per cent to 1 per cent. They all apply to earned income of residents and nonresidents and are similar to the Philadelphia income tax.

Double Taxation

The act prevents double taxation by state and by local governments. It does not do so between municipalities and school districts. The Legislature left plenty of room for jurisdictional dispute between local and municipal school governing bodies. Each may duplicate the other's taxing powers. Several municipalities may also tax the same subject. The act, however, does rule against duplication with regard to the income tax. It provides that if income taxes are imposed on a taxpayer by the municipality of employment and the municipality of residence, the municipality of residence takes precedence. In other words, if an income tax is imposed, all who work in the community must pay the tax—whether resident or not. But, if the municipality of residence also has an income tax, the amount paid at the municipality of residence is deductible from the return made to the community where the taxpayer is employed. If the tax is levied at an equal rate in both communities, the municipality of residence gets the tax in toto and there is none left for the municipality of employment. The exception is that in the city of Philadelphia, that city gets the preference instead of the resident community. In other words, if any municipality surrounding Philadelphia imposes an income tax, the city of Philadelphia gets preference and payment of the tax in Philadelphia becomes deductible from the tax due in the place of residence. As a result of this provision, none of the communities around Philadelphia have imposed income taxes.

This is a significant difference from two viewpoints. First, as you will recall in my reference to the Philadelphia income tax, the original ordinance was intended to impose the tax primarily on nonresidents, and even the amended ordinance which places the same burden on residents and nonresidents had, as its major advantage, the fact that the people who reside in the "bedroom" communities of Philadelphia were subject to a tax that supports the government of the municipality

where they earn their livelihood. This act, as you will note from my later discussion, prevents such a tax. The second major problem arising from this distinction relates to the administration of the tax and the determination of the liability of the various taxpayers.

Reciprocal Taxation

The first effect of this provision has been to create reciprocal taxation in so far as income tax is concerned. If an income tax is adopted in a community, all of the surrounding municipalities and school districts hasten to impose their own income tax. The reason is obvious. It is to keep at home this revenue where it can be used either to relieve local taxes or to provide additional services. This is money that would otherwise be payable by the residents to outside units of government in which they work. To illustrate this point, while there are 140 municipalities imposing such taxes, 122 of those taxes are imposed in 11 counties. The fact of the matter is that there are about ninety such taxing districts within four metropolitan areas. There are twenty municipalities imposing such taxes around the city of Johnstown as a result of the Johnstown income tax; about twenty-eight around Scranton; twenty municipalities adjoining Williamsport; and twenty-one adjoining the city of Sharon. Many of these municipalities are too small to administer income taxes effectively. As a result, not only is the machinery for the collection of the tax poorly established, but the cost of collection percentagewise is often very high. For example, in one borough, with a population of 604, the tax is estimated to yield about $1,200 in 1948. The administrative expense will run about $350 or 29 per cent. You can readily see what a ridiculous situation this tax produces. Certainly, no one would claim that such a tax can be administered effectively for $350 but, at the same time, it means that the municipality is actually going to receive a net return of $850 from this tax. On the other hand, the larger cities can collect the tax, with fairly elaborate administrative machinery, at less

than 2 per cent. Of the 140 municipalities levying this tax, 22 have a population of less than 1,000. The smallest one is a school district with a population of 242 persons. It is apparent, therefore, that this provision of the act has greatly hampered the income tax as a source of revenue for metropolitan areas in industrial communities.

Administrative Problems

These reciprocal taxes create some difficult administrative problems. First, the problem arises as to the means of allowing deductions and credits to taxpayers who live in one community with an income tax and work in another with a similar levy. Since the law provides that the payment of the tax in the place of residence shall be credited to, and allowed as a deduction from, the liability of such taxpayers for any other income tax by another political subdivision, the technical method would be for the taxpayer to pay the required tax to the place of residence and again to the municipality of employment. At the end of the year, he could then submit his tax receipt from his place of residence to the taxing body located in his place of employment and receive a refund for the amount that he had paid to the community of residence. This, of course, creates a lot of duplicate work for both the municipality and the taxpayer as well as an additional temporary outlay for the taxpayer.

A common practice is for the employer to deduct only the tax levied by the municipality or school district in which his place of business is located. He does not consider himself bound by the requirements of an ordinance or resolution of another local unit. Moreover, he usually has no way of knowing what municipalities have imposed such taxes, and whether employees reside in any of those municipalities. Some employers are finding it quite burdensome to keep up with the list of municipalities in which they do business that are imposing such taxes. For example, I know of one employer who happens to have a loading barge in a community where one person is employed

full-time and several persons work there a few hours a day. This employer must ascertain the number of hours that these employees work in that particular community and determine their tax liability and then transmit the money to the tax levying body.

There are several methods for simplifying this procedure to some degree. The first is for all school districts and municipalities levying an income tax in a particular area to set up a centralized system for collecting the tax once from each employee involved and for paying it over to the proper local unit or units. Such a procedure would simplify the collection of the tax, reduce the administrative costs, and reduce to a minimum the difficulty and inconvenience to the taxpayer and the employer. Some municipalities have hesitated to set up such a machinery because the larger communities who would be the logical ones to run this system feel that it would encourage a larger number of communities to impose this tax at their expense.

Another means of simplifying this procedure might be for the employee to file with his employer a request that his income tax be deducted and that the amount withheld be paid to his municipality of residence which has imposed a similar tax. Some employers have inaugurated such a system. Here, again, the larger municipalities do not want to encourage this type of simplification since they feel that it would encourage more municipalities to impose the tax.

Fortunately, most municipalities have adopted similar ordinances and forms. In practically all instances they follow the federal income tax forms so that the employer is not confronted with a variety of different types of forms and reports.

Aside from the administrative difficulties which these municipal taxes have imposed, they have also played havoc with municipal budgeting. Every new income tax in a particular area reduces the potential revenue for the municipality first levying this tax, making it difficult to estimate revenues from this tax with any degree of accuracy. Some advocate that the

ordinance be so framed as to apply only to residents, but such a move would defeat one of the main purposes of the income tax, namely, to get the income tax from persons not liable to other local taxes but using municipal services. Furthermore, the metropolitan cities would needlessly deprive themselves of the income to be derived from residents from neighboring communities which do not impose an income tax or impose it at a lower rate or at a later date.

Jurisdictional Rulings

So far there have been no cases on this new income tax reaching the State Supreme Court. One case involving the city of Scranton was handled by the Lackawanna County Court. This ruling involved several points. First, where two municipalities enact a similar tax on earnings and on net profits, the municipality of residence has priority in collection of the tax, and the amount so collected may be deducted from a similar tax which such taxpayer would otherwise be required to pay in the municipality of employment. Such provisions, the court ruled, need not be embodied in the ordinance since the law provides for this procedure. The same court also ruled that a municipality and a conterminous school district may both impose an income tax without either having priority as against the other, since both constitute the place of residence. In other words, the taxpayer residing or working in that community would be subject to both taxes.

One question that has not been decided is whether a taxpayer can deduct the same tax from two municipalities. In other words, assuming that a taxpayer resides in city A where the city imposes a ½ per cent income tax, he works in borough B which has a ½ per cent borough tax and a ½ per cent school tax, the question arises as to whether or not he can deduct the ½ per cent paid at his place of residence against both the borough and the school income taxes imposed at his place of employment.

Other Administrative Problems

Other administrative problems arise from the extreme change in the provision of the 1947 act as contrasted with previous legislation. In the past, the Pennsylvania Legislature has specifically spelled out the methods by which municipal taxes are to be collected, provided for an elected tax collector, as well as the dates when the taxes are due and payable, at discount, at face, and at penalty. The acts also provided for specific rates of discount and penalty. This act of the 1947 Legislature, known as Act 481, authorizes the municipalities to provide, by ordinance, for the creation of such personnel and the imposition of such penalties and regulations as may be deemed necessary for the collection of taxes imposed under this act. Consequently, various arrangements for the collection of these taxes have been included in local ordinances and resolutions. Some provide for the collection by the existing tax collector, who is an elected official, while others have imposed the duty on the secretary or the treasurer. In some instances, special bureaus are created such as the Commissioner of Income Tax in the city of Johnstown.

The laws relating to tax collection provide that the local tax collector shall collect all taxes levied by the particular taxing district. Whether this is in conflict with the provisions of the later act has never been determined. The general opinion is that since Act 481 of 1947 was passed after the various municipal codes, that it superseded these provisions.

The question often raised is whether a local unit has the right to require employers to act as collectors and reporting agents without compensation. In fact, some employers have refused to withhold the tax on those grounds and cases are now pending in local courts, but no decision has been rendered on this question. Another question which often arises and in which no decision has been made is whether a municipality can demand the withholding of the tax from an employer who has no business office in the municipality imposing such a tax.

These administrative problems, however, have not deterred municipalities from imposing the income tax especially where the major city has imposed such a tax. The provision which has deterred the wider use of this tax is the one that I mentioned earlier which permits reciprocal taxation by adjoining communities. In the city of Pittsburgh, for example, some of the taxpayers, who are now subject to various types of taxes imposed by that city under Act 481, have indicated that the city might impose an income tax in lieu of the other taxes. The city officials have maintained that Section 5 of the act which permits the deduction of the tax by places of residence would, in effect, result in an income tax on the residents of Pittsburgh alone, which, to their way of thinking, made the tax undesirable. Possibilities are, that if such a provision were not included in the act, an income tax might have been considered in a more favorable light by the city officials of Pittsburgh.

Conclusion

It is apparent, therefore, that the income tax in Pennsylvania's local communities outside of Philadelphia is quite different from that of the city of Philadelphia, where one of its major advantages has been that it has subjected a lot of persons with substantial income, who maintain their offices in Philadelphia but live in the more desirable suburban areas, to a tax within the city of Philadelphia. In other municipalities, that advantage has been taken away because the act applies to too many municipalities. No doubt, some effort will be made at the next session of the Legislature by some of the larger cities, to amend that provision and give the city of employment priority instead of the place of residence. Pennsylvania's legislature is predominantly rural in character, as are the legislators of most states, and they will probably not look with much favor on such a recommendation. Barring such an amendment, the income tax will be primarily a tax on residents only.

The reciprocal income taxes imposed under Act 481 by the suburban communities have, in the main, taken the form of

spite taxes. They have deprived the area which is in greater need of revenue, namely, the metropolitan cities, from a substantial source of revenue and have distributed that amount among a large number of smaller municipalities where it produces little revenue. These smaller communities have all copied the Philadelphia income tax ordinance and have attempted to prescribe an administrative mechanism, which, while proper for a large city like Philadelphia, has no application in a smaller community. The result has been a tearing down of a tax which has proven meritorious for larger cities.

However, despite its limitations, this tax is being extended all the time. The cities of Altoona and New Castle, for example, are now in the process of passing ordinances imposing an income tax for the year 1949 and, no doubt, this will be followed by another group of municipalities surrounding those cities. For despite its limitations, the income tax has proven financially lucrative to the larger cities. This tax is being imposed in most cities for the reason that it is the only broad base tax available and practical for local governments.

CHAPTER XXXVIII

ACTUAL PROBLEMS INVOLVED IN SETTING UP LOCAL INCOME TAX ADMINISTRATION

CARL C. TILLMAN
Commissioner of Taxation, City of Toledo

THE PROBLEMS involved in setting up a local income tax administration depend upon the specific compliance provisions of the legislation imposing the tax, the requirements of the state code or local charter covering the receipt and recording of municipal revenues, and the entire procedure then tested by sound accounting practice.

The Toledo income tax ordinance (No. 18-46, passed January 28, 1946, effective March 1, 1946) levies a tax of 1 per cent on the gross salaries, wages, and other personal compensation received by employees who are residents of, or work in, Toledo, and 1 per cent on the net profits of business, both corporate and unincorporated. Further, the ordinance provides that:

The tax is to be withheld by local employers from the wages, salaries, commissions and other personal compensation of all employees employed in Toledo at the time such wages are paid, and remitted to the City of Toledo on or before the 15th day of the month following the month in which the withholding occurs, on a form provided by the Commissioner of Taxation (Section 6);

All taxpayers, both individual and others, having taxable income from which full tax liability will not be withheld, are required to file a Declaration of Estimated Toledo Income Tax on or before the 15th day of March, 1946, and each year thereafter, covering the estimated tax for the year, or within 75 days after the beginning of a fiscal year other than the calendar year. The tax is payable in equal installments, the initial payment accompanying the declaration, and subsequent payments due each 75 days thereafter (Section 7). Amended Declarations may be made at any payment date;

All taxpayers required to file declarations are also required to file a tax

return on a form provided by the Commissioner of Taxation, on or before the 15th day of March following the year in which the income is received, or within 75 days after the close of a fiscal year or period differing from the calendar year (Section 5);

It is the duty of the Commissioner to collect and receive the tax imposed by the Ordinance, keep an accurate record of the amounts received from each taxpayer and the date thereof, enforce the provisions of the Ordinance, furnish the forms necessary for taxpayers' compliance, and to adopt and promulgate rules and regulations (Section 8).

With only about thirty days between the time of the passage of the ordinance and its effective date, it was necessary that several things be done practically concurrently, as follows:

1. Secure suitable office space.
2. Prepare an estimated budget of the anticipated expense of administering the ordinance.
3. Arrange for the purchase of necessary equipment and supplies.
4. Employ capable personnel.
5. Adopt rules and regulations and arrange for the printing and issuance thereof.
6. Prepare a list of potential taxpayers from whom declarations and withholdings would be required.
7. Devise and procure necessary forms for use of taxpayers.
8. Attend numerous meetings and conferences to explain the provisions of the ordinance, and to carry on an educational campaign to defend the ordinance at the referendum.
9. Arrange for the proper receiving, recording and depositing of all tax receipts.

Office Space

We were able to rent the top floor of a four-story building just being redecorated for office purposes. This floor had an area of approximately 7,600 square feet and the existing arrangement of offices seemed to fit in well with our needs. Having all activities located on one floor is a decided convenience and much to be desired wherever such an arrangement is possible. Although the building is not located adjacent to the City Hall, it is but a few blocks away and just on the fringe of the crowded downtown area where adequate parking space is available.

Budget

The preparation of a workable budget was a nightmarish estimate. Obviously, it would take at least two years to complete our organization, much depending upon delivery dates of equipment and supplies, both of which were extremely scarce. Not only was an appropriation necessary to cover the ten months of 1946, but Council also wanted an estimate as to the approximate costs for each of the four years following. Before any estimate for budgetary purposes was possible, it was necessary to anticipate practically the entire system so we would have some idea as to the number and type of personnel, the equipment required, the necessary essential forms to be used, etc. It was finally decided that our budget for the ten months of 1946 would approximate $149,900, of which $27,500 was for equipment. Our actual expense for operating the division other than for the purchase of equipment was $94,900 for this period. With anticipated revenues aggregating $6,000,000 per year, it appears that the cost of administration will approximate slightly more than 3 per cent.

Equipment

Since the ordinance requires that an accurate record be kept of the amounts received from each taxpayer and the date thereof, this indicated the use of equipment which would satisfactorily record this data on a ledger form and, as good accounting practice would indicate the advisability of sending a notification to taxpayer in advance of each quarterly payment date, the posting machine to be used should be of such a nature as to accomplish this result. Also, for statistical purposes, it should accumulate totals with respect to the total amount declared by all taxpayers, the amount of payments made thereon, the effect of any adjusting journal entries required, and the total of any increase or decrease from the original declaration as indicated by the final tax return. Our analysis of the situation indicated that two machines would be required since it would be neces-

sary to record the declaration and initial payment, three subsequent payments, and the final payment accompanying the tax return and the receipt of taxes withheld by employers. As there was absolutely no chance of securing these machines out of stock we were fortunate in having the Burroughs Adding Machine Company loan us a machine which enabled us to get started until our own machines could be delivered.

Three payment notices would be required as well as the forms to be used by withholding employers for reporting the amount of tax withheld and to accompany remittances. It was decided it would be most advisable to have these forms pre-addressographed as taxpayer's name was recorded on our records so as to give the taxpayer an opportunity to make any corrections necessary. These forms are both pre-addressed and mailed in window envelopes. The pre-addressing is done by addressograph equipment, and orders were placed for a Model 1900 addressograph with automatic feed, a proofing addressograph, and a graphotype for cutting the plates. Here too, a delay was indicated in securing the equipment, but we were fortunate in having equipment loaned to us by the Addressograph-Multigraph Company and also having them cut the original plates. These plates are used for embossing all ledger accounts as well as all notices and tax returns.

Personnel

Since the ordinance was passed for a limited period, expiring December 31, 1950, it was considered as being a temporary measure and the employees were not subject to Civil Service. Consequently, we were unable to secure qualified employees from other city departments. All employees were hired from the outside and only in sufficient numbers to carry on the work at hand. In selecting these employees this matter was left to the discretion of the Commissioner and no political pressure was applied in any phase of our activities. I attribute much of the success of our organization to the excellent cooperation re-

ceived from Mr. George N. Schoonmaker, our City Manager, and to the members of the Council.

As the work of organization progressed and needed equipment became available, additional employees have been added from time to time. Our payroll for the first half month included seven employees, while at the present time we have fifty-four. It is doubtful if this number will exceed sixty employees during the life of the present ordinance. All male employees were hired as investigators and, as our organization progressed, promotions were made to higher classifications. All city employees are now on a point basis which indicates the annual salary, and are serving at the minimum rate for one year and then automatically advancing to the maximum rate of the particular position classification.

Rules and Regulations

Preparation of rules and regulations was handled by the Law Department, and many bull sessions were held nightly in order to eliminate as many bugs as possible. Inasmuch as the ordinance levied a tax on "net profits earned" of business and provided an allocation formula, considerable thought was necessary in covering these two features. Also, we had to stay away from any field already pre-empted by the state, such as income from intangibles, and to eliminate income which could not be clearly defined as earned income. Much confusion existed during the early days because of the federal concept of income, which includes practically all income, as against the Toledo concept of earned income only. Meetings were held with groups of accountants, attorneys, and others to acquaint them with the requirements of the ordinance so that they could properly advise their clients. We were fortunate in having excellent cooperation from them, as well as from employers.

List of Taxpayers

Although the ordinance does not require that forms be mailed to the taxpayer, we felt this was the logical thing to do

and each form mailed is accompanied by a return envelope. This necessitated our securing a list of potential taxpayers from whom declarations and withholdings would be required and this list was made up from our local telephone directory, as well as the directories of various trade associations. In this way we were able to start out with a fairly comprehensive list, at least so far as business was concerned. The most difficult names to secure were those who were employed in other governmental agencies from whom tax withholding could not be required, those individuals having income from a business carried on from their homes, and residents working in plants outside the city whose employers could not be required to withhold. We had very fine cooperation from the federal offices as well as the county and the school board. We have been doggedly after those residents working for firms outside the city and such taxpayers are being added daily to our records. During the past year many of these outside firms, at the request of their employees whom we caught up with, began to withhold the tax. This naturally is most helpful to us as it reduces the number of accounts we must maintain and relieves the employee of a considerable amount of bother in filing a declaration and return and making quarterly payments.

Forms

The first form required was a form of declaration of estimated tax and for this purpose we followed the pattern set by the federal government, with the exception that our declaration indicates the amount of income on which the tax is estimated. These first declarations were mailed on the sixth of March, 1946, and the time for filing extended to March 31, 1946. The form carries full instructions as to how the declaration is to be made up and what constitutes income or net profits earned, as well as the various types of income excluded. The original folds over so that a carbon copy can be made for taxpayer's records. We then considered the form of ledger account to be used as well as the type of quarterly notice to be

sent, in advance of the next quarterly payment date, to all taxpayers not having paid the tax in full when filing the declaration. When the amount declared and the initial payment are posted, the remaining balance is automatically transferred to this quarterly notice, which we call Q-1. When pre-addressing these forms the addressograph indicates the taxpayer's serial number, name, and address, and also that one-third, one-half, or the balance of the amount indicated is due at the particular date.

Since the ordinance required that employers must withhold the tax from wages paid after March 1, exclusive of that portion earned previous to March 1, and was to be reported and remitted on a form furnished by the Commissioner, this form had to be devised quickly so that the employer could comply with the ordinance on or before the fifteenth day of April. After four months of this we finally prevailed upon Council to pass a supplemental ordinance (234-46, July 15, 1946) permitting the reporting and remitting of withheld taxes on a quarterly basis the same as federal income taxes. This remitting form is known as our W-1.

Both of these forms are of the snap-out design with carbon interleaved. The original and duplicate are mailed to the taxpayer, who uses the original to accompany the remittance. The triplicate and quadruplicate are retained in our file and are withdrawn as payments are made. At the expiration of the payment date all remaining copies indicate delinquents and the triplicate is used for mailing in a window envelope as a delinquent notice. We were also subject to delay in securing these forms due to the paper shortage. Therefore, we had substitute forms printed locally, hand-folded, and carbon inserted.

Referendum

Shortly after the ordinance became effective referendum petitions were circulated and a special election set for April 11, 1946. In the interim, in order that they might have complied with the ordinance, several thousand taxpayers filed declara-

tions covering their estimated taxable income for the ten months and only paid a tax on approximately one-tenth of such income, or merely filed token declarations, on the theory that the electorate would knock out the ordinance. All such declarations and their partial payments had to be recorded. In the meantime, numerous meetings and conferences were held with various groups explaining the provisions of the ordinance, the necessity for this additional revenue, its effect on citizens and taxpayers, the strong financial condition which the city would enjoy as a result of the tax, etc.

When the ordinance was upheld by a majority of the electors it was then necessary that these taxpayers file amended declarations and make remittance of the balance of the required initial payment. This made double work for the division at the very onset and at a time when untrained personnel and lack of equipment tested our resourcefulness to the limit.

Receiving and Recording Taxes

Because of the difficulty in securing equipment and supplies, even office furniture being at a premium, our accounts were set up in alphabetical order. You can appreciate that similarity of names, poorly written signatures, and changing addresses gave us quite a few headaches. You would be surprised at the number of different ways one taxpayer can write and spell his own name. This resulted in our setting up duplicate accounts for the same taxpayer and dunning him for a payment already made under a slightly different name or address. When we look back now over those early days we wonder how we ever kept anything straight. We even had taxpayers send us silver money in an envelope without postage and without any indication as to who sent the money. We are rather proud of the fact that, after being in business over two and one-half years, and collecting in excess of $14,000,000, we have a net cash overage of about $11 and unapplied remittances of less than $200.

We have four bank teller machines used for receipting of all taxes paid by taxpayers. These machines imprint on both the

taxpayer's copy and the file copy the date, transaction number, and amount of the payment and this same information is recorded on a tape. The type of form filed is indicated by a code and deposits are made up according to these tapes. All moneys received are deposited with the city treasurer and postings to the taxpayer's account are made according to these individual deposits. A daily report of taxes received and so deposited is made to those officials concerned therewith, and a monthly report is also made indicating the receipts for the month and year to date, together with any refunds made during that period. These monthly reports are publicized in the City Journal and, of course, any citizen or taxpayer can get full information from us as to these figures. However, no information with respect to any particular taxpayer is given to any but the taxpayer himself, and no such information is given over the telephone to anyone.

General Organization

As the organization advanced and necessary equipment became available, we were able to departmentalize our activities. Where at first our employees were used at any task required to be done at the moment, we are now set up along the following lines.

We have an attorney who handles all legal matters and acts as deputy commissioner.

A chief auditor has direct supervision over the audit staff and the investigation department. He is assisted by an assistant chief auditor and a supervisor of investigations. The field auditors make office and field audits of all taxpayers' records where so required, while internal auditors are used for supervising internal details. The investigators are in the field looking for new businesses as well as checking up on all evasions. Both investigators and auditors assist taxpayers at filing periods in preparing the necessary returns.

The addressograph department maintains a constantly corrected list of all taxpayers and pre-addresses all necessary forms.

This list consists of a four-part index covering all taxpayers, in numerical serial number order, in alphabetical order by corporate or trade name of taxpayers, in alphabetical order by individual or owner's name, and in alphabetical order according to street addresses.

We have recently rented microfilm equipment from Recordak for fire protection purposes. At stated periods throughout the year, when it is possible to do so, a film is made of all ledger accounts and, as postings are made to these accounts a film is also made of the posting media. One set of films is kept in our office for use when necessary, another set is kept in a fireproof building. In this way, should a fire destroy our records, we would be able to replace them from these films. As each copy is filmed the machine automatically inscribes this fact so that the file room can detect any items which may have escaped microfilming.

Throughout the entire administration of the ordinance we worked on the premise that our office was to serve as a collection agency for the convenience of taxpayers and that the proceeds of our endeavors would eventually inure to the benefit of the citizens. Consequently, we have endeavored to be as cooperative as possible at all times, and at the same time conduct our administration fairly and equitably. We recognized the withholding provisions would be an additional burden on employers and it has been our constant practice to minimize this burden wherever possible. In return we enjoy the confidence and cooperation of our taxpayers and are rather proud of the fact that we have been spared much of the criticism to which public offices are at times so vulnerable.

CHAPTER XXXIX

THE TAXPAYER ANGLE ON LOCAL INCOME TAX ADMINISTRATION

H. G. Homuth
Treasurer, Jewel Tea Company, Inc.

I AM HAPPY for the privilege extended to me of representing the local taxpayer in this forum on the subject of local income tax administration.

In thinking about my remarks today I was surprised to discover that this subject of income tax dates far back beyond 1913. I had always supposed that the first general income tax law of that date was the beginning of all income taxes. I discovered in reading a recent issue of *Fortune* magazine, however, that we had an income tax as early as 1862 in the United States and as far back as 1692 in Great Britain.

In fact, the income tax principle goes back before the time of Christ. It is my understanding that Plato, who lived back in the period from 427 to 347 B.C., had this to say about income taxes: "When there is an income tax, the just man will pay more and the unjust man pay less on the same amount of income."

No Axe to Grind

In accepting this assignment I do want to make clear that I have not come here to crusade against any particular tax or method or procedure, but rather for the purpose of focusing attention on some of the problems faced by certain groups of taxpayers, which are generally ignored by those who draft tax laws and tax regulations.

In using the word, "ignored," I do not wish to imply that the framers of tax legislation are deliberately and willfully closing their eyes to these problems, but rather that they are probably unaware of some of the less obvious and more unusual characteristics of certain industries such as the one I represent; and, for that reason, little or no provision is made in current tax legislation to make it fit the type of situations which I shall attempt to describe.

Generally, tax plans, particularly those drawn for small communities, are tailored to fit the industries which are the most obvious—those such as the manufacturing or processing plant, the retail store, or the business office. They are the ones you can see. They catch attention and for that reason their problems are, to a large extent, considered in framing local tax laws.

An example, illustrating the degree to which our type of industry is overlooked, may be found in a recent experience we had with the city of Scranton. We had been writing about certain aspects of the Scranton tax. In one of his replies, the city treasurer included a list of towns around the city of Scranton, each of which had enacted income tax laws in recent months. Despite the fact that we operated in many of these towns, there was a total of sixteen about which we had absolutely no information in our files or in our tax service, nor did any representative of those towns apparently make any effort to notify us of the tax laws—despite the fact that we might have been subject.

Appreciate Need for Local Taxation

Perhaps I should hasten to add that I do have some appreciation of the problems faced by the various taxing bodies. For some years I served as president of the Park Board in my local community and in that capacity, I had to be concerned about obtaining sufficient tax income and other revenue to keep abreast of the ever shrinking purchasing power of the dollar and the consistently increasing demands of the public for additional services and facilities.

In our particular part of the country, public tax bodies are subject to laws which make it difficult to operate on a sound budget basis and on good business principles. It is practically impossible to build up sinking funds to meet large anticipated expenditures. In fact, the entire body of the law, with reference to the financing of the Park Board, for example, is predicated on operating one year behind the receipt of income.

My education in the problems of taxing bodies was broadened by a very unique experience having to do with the fact that our local community has a county line running almost through the middle of town. This means that there are two separate taxing bodies involved in the makeup of the tax rate for the citizens of the town.

In 1943 Assessor Clark of Cook County developed his famous 100 per cent valuation formula and applied it to the valuation of property in Cook County including that portion of Barrington lying in Cook County.

The other county continued to operate on its customary basis of valuing property at around 20 to 22 per cent of full value. Thus it developed that the people in Barrington who lived on the Lake County side paid only about one-third of the tax compared with the people living on the Cook County side. In other words, a Lake County taxpayer, whose tax formerly had been about $80 a year, found his tax reduced to somewhere around $50; whereas, a comparable piece of property on the Cook County side of town would have a tax of about $150.

After living through the many tax protests and public hearings required to straighten out this mess, I was almost ready to hang out my shingle as a tax consultant.

Furthermore, as a taxpaying homeowner, I subscribe to the attitude of Mr. Carl J. Faist, Director of Finance, Saginaw, Michigan, who recently had an article in the *Saturday Evening Post,* in which he made the following statements:

I am an ordinary citizen of a typical American city. Last year my taxes were $1,174.78. Of this amount my local tax was only $95.18. For my city tax of $50.54 per year I get police protection for myself and family, my

home, my car and my bank account. I get fire protection day and night the year around for my house and its contents. I get safe pure water delivered to my home and the sewage removed. I get traffic lights to drive by, street lights, bridges, sidewalks, pavements, voting facilities and a goodly number of parks and playgrounds. I get health protection through the city's food, milk, restaurant and sanitary inspection. Last night I enjoyed a fine free concert by our municipal band. Twice during the past year I have been given valuable information by our city clerk. The street in front of my house was cleaned ten times last summer, and the snow was removed six times during the winter. Our system of garbage removal isn't all that could be desired, but at least I have reasonable service on that disagreeable job.

For my school tax of $26.79 I have been permitted to send two daughters through grade school and high school. The health, safety and education of my children are mighty important, representing three of the biggest goals of my life. My home and my job are also mighty important to me. My local government protects them all at a cost last year of only $95.18, compared with my federal taxes of $1,079.60, with the latter representing about one-fifth of my entire income.

I agree with Mr. Faist that we receive a great deal in return for our local tax dollars in most American communities today, and I believe our job as citizens is to be just as cognizant of the problems of providing adequate income to our municipalities as we are of the size of our tax bills.

Jewel Background

As I have stated heretofore, most of these local income tax laws are ignoring the problems of certain groups of taxpayers, of which, perhaps, our company is a good example.

To help you understand our difficulty I would like to describe very briefly our method of operation. We operate in forty-three states, and these forty-three states are served by seventy-seven branch warehouses. Each of these warehouses services perhaps twenty-five motorized routes, although the number varies up to fifty in some locations. Each motorized route serves around six hundred customers, covering a cycle of two weeks, after which the salesman repeats the cycle again with the same customers.

At each call the salesman delivers the products ordered last time by the customer and then takes her order for delivery

two weeks hence. So far the operation is simple, but now it becomes complicated in view of the administration of local taxes, unemployment compensation, workmen's compensation, and other regulatory measures.

A route may operate entirely within a city or it may spend a day or two in a number of individual small towns—in fact, it may spend as little as a third or a fifth of a day in one or more small communities in the course of its two-week cycle of operations.

Many of our branches have motorized routes which operate in more than one state, and in some cases a branch warehouse may have routes operating in as many as four different states. As you can see, therefore, a branch may serve a large number of communities with individual routes crossing the boundaries of a great many individual towns and cities.

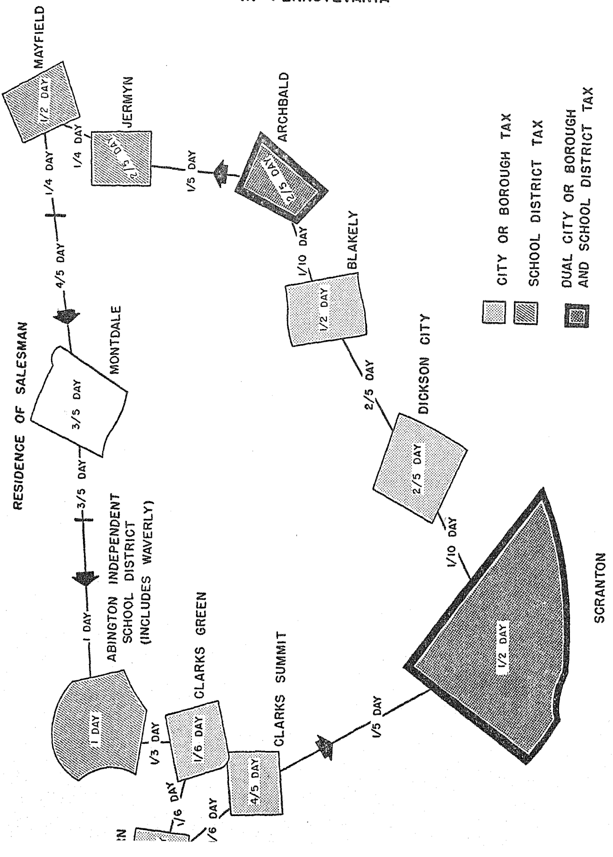
Basic Problems

To give you the picture in a nutshell of the basic problems induced by many local tax laws, we have prepared an illustration involving a hypothetical route operating in some of the small communities in the area adjacent to Scranton, Pennsylvania. We have routes in this area, many of which have some of the problems mentioned here; but, for purposes of focusing attention on the complicated administrative difficulties involved in complying with the withholding tax laws of the cities in this area, we have drawn an illustrative route which covers a territory involving twelve different taxing districts, each having an income tax law.

For the sake of making this illustration clear, a chart has been prepared showing a picture of the operations of this route. In this illustration our salesman lives in and is headquartered in the town of Montdale, Pennsylvania, which, according to the latest information available, had no income tax law.

During the course of the ten-day cycle, this salesman spends some time in each of twelve towns or other taxing districts which have income tax laws; and, in addition, of course, he

HYPOTHETICAL ROUTE OPERATION
SUBJECT TO MULTI-CITY INCOME TAXES IN PENNSYLVANIA



works in areas where there are no such laws. The light shading indicates cities or towns which have enacted income tax laws and the intermediate shading indicates school district income tax areas. The heavily shaded areas are those containing two jurisdictions each having an income tax law.

Time spent in income tax areas varies from as little as one-sixth of a day to as much as one full working day. In total, this man spends four and four-fifths days in towns where his earnings are subject to income tax out of the total of ten working days in his cycle of two weeks. Computing the tax liability on this man's earnings for each of these twelve towns is quite an operation; however, if the conditions were static and not subject to change once the ratios were worked out any ordinary clerk could apply them week after week.

Unfortunately our customers are human, and as a result we find it necessary to accommodate our operations to them. Some of them leave us for various reasons—sometimes to move to other parts of the country, sometimes to move into a new home in the country or a suburb, sometimes death breaks up a family—and thus for many reasons we find it necessary to replace the customers who leave us. These new customers, plus those who move but who continue as our customers, cause a constant shift in our routes and in the ratios of time spent by our salesman in the various communities served in his two-week cycle of operations.

This fluid condition of our accounts makes it difficult to compute a series of ratios for the purpose of allocating the earnings of a salesman as a basis for tax computations. Every few months those ratios change, and this means a considerable amount of work and expense in trying to keep up to date on the administration of local withholding tax laws which are predicated upon an allocation of income rather than on residence only.

A further complication arises out of the fact that our salesmen receive salaries which are based to a large extent on their sales volume. Thus every four weeks a salesman's salary will

change up or down, depending on his volume for the preceding four weeks. This means that the amount of an individual's tax must be ascertained anew every four weeks, in addition to the computations needed to adjust for variations in earnings due to illness and other reasons for time lost.

Basic Problem Not Confined to Jewel

Before you throw up your hands in despair, saying that you did not come here to hear about the tax woes of any one employer, I would like to tell you that our company is not alone in having these problems. There are many others in exactly the same type of business.

There are about two hundred companies operating home service routes in this country exactly like the ones I have described. Of this number, fifty-two companies operate in Ohio and Pennsylvania, where the withholding tax principle is being applied to local income taxation to an increasing extent at the present time.

In addition to the two hundred companies operating home service grocery routes such as ours, there are a great number of other route industries which are affected to a very similar extent. They include milk routes to both homes and dairies, bakery routes, auto part routes, the auto delivery trailer type of operation, laundry routes, frozen food routes, butter and egg routes, diaper service, gasoline delivery both to tanks and stations as well as fuel oil deliveries to farms and homes, fruit juice routes, to say nothing of the aluminum salesman, Real Silk salesman, paper and stationery salesman, vacuum cleaner salesman, soft water routes and, of course, the Fuller Brush man.

Other Problems

Now that you have a little better understanding of how vital home service is in our American way of life and the extent to which industries of this type are woven throughout the fabric of our economy, you can see a little more clearly that, as local

taxation continues to develop in the direction it has taken, more and more companies and employees are going to become immeshed in the red tape of a very cumbersome tax administration.

A typical local tax ordinance makes no effort to cover the problems of an operation such as I have described. It simply specifies a tax rate to be applied to salaries, wages, commissions, and other compensation earned by residents or nonresident employees of the community.

Where the employer is required to withhold taxes in a situation such as the one I have discussed, what is the employer expected to do? Suppose in the case I mentioned the salesman was earning \$85 a week. If a certified public accountant were employed he might figure out the tax bill by allocating the salesman's earnings to the various communities in which the

INCOME TAX WITHHOLDING COMPUTATIONS FOR HYPOTHETICAL ROUTE IN PENNSYLVANIA

Day	Days Spent In Tax Jurisdiction	Tax to be Withheld For	Tax Rate	Wage Apportionment	Tax Withheld
#1 day	full day	Abington Ind. School Dist. (Includes Waverly)	1%	\$17.00	\$.17
#2 day	1/6 day	Clark's Green	1%	2.83	.03
	1/6 day	Glenburn	1%	2.83	.03
#3 day	4/5 day	Clark's Summit	1%	13.60	.14
#4 day	1/2 day	Scranton	1%	8.50	.09
		Scranton School Dist.	1/2 of 1%		.04
	2/5 day	Dickson City	1%	6.80	.07
#5 day	1/2 day	Blakely	1%	8.50	.09
#6 day	2/5 day	Archbald	1%	6.80	.07
		Archbald School Dist.	1/2 of 1%		.03
	2/5 day	Jermyn School Dist.	1/2 of 1%	6.80	.03
#7 day	1/2 day	Mayfield School Dist.	1%	8.50	.09
#8 day	None		No tax		
#9 day	None		No tax		
#10 day	None		No tax		
10 days	4 4/5	12 taxing jurisdictions		\$82.16	\$.88

Total tax withheld for two-week pay period	88¢
Number of taxing jurisdictions	12
Average tax withheld per jurisdiction	7.3¢

12–3–48

salesman worked during his two-week cycle based on the days or fractional days spent in each place. In that case the public accountant's tax computation would look something like the one presented in the following example.

You will notice that, after making twelve divisions of income and twelve multiplications of the allocated earnings by the individual tax rates, then adding up the column of twelve tax figures, our public accountant would arrive at the grand total of eighty-eight cents tax due for the two-week cycle of operations. This is an average of about seven cents for each of the twelve communities involved. For an entire year this would be an average of about $1.90 for each of the twelve tax bodies.

Those of you who know anything about corporate procedures and the safeguards for the spending of company money will readily understand that it costs more to draw the checks and prepare the letters of transmittal to remit the taxes to each of these communities than it does to pay the actual tax.

Allocation Problems

The illustrative route diagrammed on the chart on page 334 did not indicate an income tax imposed by the city in which the salesman lived. Had there been a tax on the earnings of the employee imposed by the city of his residence, I am not sure that anyone would know how to compute the employee's tax liability—much less to determine what amounts should be withheld from his salary each week for what cities.

While we are not at all sure about the answer in such a case, some people think that the following handling might be correct.

Let's assume a situation where the employee's route brings him into only three towns as follows:

The city in which the employee resides seems to have a priority; and on that basis the employee's entire earnings, regardless of where earned, are taxable. Thus in this case the employer must withhold a tax of fifty-one cents for city A.

Pay Period of Two Weeks

Town	Days Spent	Income Allocation	Tax Rate	Amount of Tax
A (city of residence)	3	$170	0.3%	$.51 *
B	5	85	1.0	.85
C	2	34	1.0	.34

* Based on total earnings, regardless of where earned.

City B has a tax bill for earnings within its jurisdiction of eighty-five cents and city C of thirty-four cents.

However, under the enabling act of the state authorizing city income taxes, it seems that the tax in the city of residence may be offset against the tax due in the other communities. Thus this employee has a liability to town B of thirty-four cents, representing the difference between the gross amount due town B of eighty-five cents and the fifty-one cents payable to city A.

He owes no tax to town C, we are informed, because that tax is completely offset by the fifty-one cents tax in town A.

Of course, you understand that any allocation of earnings by cities must have some basis in fact. This in itself means a change in procedure and added work for many companies because I am sure no one now builds up payroll figures according to the various places in which the employee's work is performed. You usually compute earnings on the basis of a straight salary for time worked, or hours worked, or on production, and not on a location basis. Furthermore, how it is physically possible to withhold taxes currently where the principle of offset must be applied is a question to which many firms would like to have an answer.

In retrospect, of course, the computation of the employee's tax liability isn't too difficult, but try to handle withholding currently, when the amount of time spent in any one city and the amount of sales volume, as well as earnings, vary from pay period to pay period. This is a problem which does not lend

itself to easy solution when one tries to withhold taxes currently.

There is, of course, the additional problem of overlapping jurisdictions which may cause multiple taxes on the same income. In this connection I am sure many of you are aware of the *Glen Alden Coal Co.* case recently decided in the Court of Common Pleas of Lackawanna County. As I understand it, the employer in this case was doing business in Scranton as well as in the borough of Taylor. The employee involved resided in the borough of Taylor but worked in the city of Scranton.

The employer deducted $4.00 from the employee's wages and was told by the employee to pay that amount over to the borough of Taylor (residence). Not only the borough itself, but also the school district of the borough of Taylor, in addition to the city of Scranton, *each* levied a 1 per cent tax—equal in this case to $4.00 each. In deciding the case the Chancellor held that the employer had not withheld enough in the first place. The employer, he said, should have withheld 1 per cent for the borough of Taylor, 1 per cent for the city of Scranton, and 1 per cent for the school district of Taylor. The employer then should have paid over $4.00 to the borough and $4.00 to the school district. He should then have offset these amounts against the amount owing to the city of Scranton. Then no tax would be left owing to the city of Scranton.

In this case the court said that where several political subdivisions impose earnings taxes and the taxpayer pays the taxes at his place of residence, he may credit any such payments against the tax owing to the taxing body in the place where he works but where he does not reside.

Where, however, two political subdivisions are coextensive territorially, as in the case of the borough of Taylor and the school district of Taylor, then the employee is liable for both sets of taxes and in such a case he may not offset one tax against the other.

Miscellaneous Problems

In addition to the administrative complications described in connection with the application of local income tax to our type of business, there are other difficulties faced by the employer who operates in a number of these taxing jurisdictions. They include:

No Uniformity in Tax Reporting Periods

Some cities want monthly reports by individual names; others want quarterly reports; still others want reports semi-annually; and, of course, still others believe once a year is sufficient. One school district even wants the tax remitted and a report prepared every time a tax deduction is made from the salary of an employee. Such inconsistency makes reporting an expensive operation for the multi-location employer.

No Uniformity in Tax Reporting Forms

They say that the income tax return is the most imaginative fiction being written today. I suppose that refers to the person signing the return. Those who designed these forms lacked no imagination either. They used great ingenuity in working out the arrangement, size, shape, and color of the returns. A great deal of originality was employed in making the forms dissimilar one from the other. No doubt this problem will be solved during the course of time as it is being solved with respect to the reporting forms used by the various states for unemployment compensation and income tax information returns.

Audit of Employer's Records

Most cities reserve the right to make audits of employer's records in order to ascertain the correctness of the tax returns made. So far, at least, few have exercised that right, but imagine the confusion which would result if all of the cities served by a Jewel branch of about twenty-five routes each had a withholding income tax law and suppose further that each city exercised

its right to make an annual audit. If the average route operated in only five different towns, there would be a total of one hundred twenty-five audits made of our branch payroll records during the course of a year—to say nothing of the other audits required for federal and state unemployment compensation, federal old-age, federal wage and hour, state workmen's compensation, etc.

Release of Confidential Payroll Information

All of us are aware of the abuse which sometimes creeps in when the salaries of individual employees are not kept as confidential as they should be. Consider the problem then when payroll information is going to be released to the village board of trustees or the town council of cities and towns in the neighborhood of three to five thousand population.

Cost of Administration

I am sure most of you recognize the cost of payroll administration has increased astronomically since 1935. Subsequent to that date the payroll departments of practically every company have grown tremendously as a result of the following added detail:

1. Payroll deductions for federal Social Security.
2. Payroll deductions for unemployment compensation in certain states.
3. Federal income tax withholding.
4. State income tax withholding.
5. Seven of the states in which we operate have withholding tax provisions.
6. Cash sickness disability withholding in certain states.
7. Federal wage and hour law compliance and records.
8. Quarterly reporting by individual names for federal Social Security purposes.
9. Quarterly reporting by individual names for unemployment compensation tax (in forty states, for Jewel).
10. Annual reporting of individual incomes with copies to employees for federal withholding tax.
11. Annual reporting of individual incomes for state income tax (in thirty states in which we operate).

Now, as rapidly as we can keep up with them and to our best knowledge and belief, we must comply with a large number of city withholding tax laws in Pennsylvania, Ohio, Kentucky, and Missouri, with a number of others indicated which may be effective in the near future.

All of this is, of course, in addition to the special payroll deductions and other records required for our profit-sharing retirement plan, group hospitalization, and many other purposes.

Due to the minute detail involved and the small segments of our business subject to local income tax withholding, compliance with such laws is perhaps the most expensive job of any which have been imposed upon us. Our accountants tell us that the cost of complying with local income tax withholding is now running 12 per cent of tax collections, not including executive and supervisory time. If some allowance was made for that portion of the cost, I am sure the total would run somewhere in the vicinity of 18 to 20 per cent of tax collected, at least at the present time.

In contrast to this expensive administration, you may be interested to know that the cost of handling social security deductions and reporting names and salaries averages only 3.7 per cent of tax collected for our company. I have used that comparison because the tax rates are comparable with those involved in local income tax withholding.

Tax on Company Profits

In seven cities in which we operate, the income tax laws apply not only to wages and salaries but also to the income for our company operations. This situation will vary, of course, according to the laws of each state. Thus the cities in some states may have the power to tax profits while the cities in other states may not.

I am sure I need not tell you that the computation of profits applicable to sales in a small town where a man spends only

one-third or one-fifth of a day every two weeks does not lend itself to accuracy.

Just imagine the size that our tax department would become if each of the fifteen thousand towns and cities in which our company operates should adopt an income tax law which included a tax on company profits.

But this phase is the least important criticism to my way of thinking. I don't believe that using company or corporate profits as a base for local income taxation is a sound principle because there is little or no relationship between such profits *or losses* and the services required of a city or town by a business firm, particularly one doing an interstate operation.

The mere fact that a company may operate at a loss sometimes over a considerable period of time should alert a city administration to the fact that a tax on company profits for purposes of supporting a city government would not be equitable and might place the city in a precarious position with respect to income, particularly during hard times.

Recommendations for Local Income Tax Administration

We now come to the subject of recommendations for minimizing the problems previously mentioned in connection with the administration of local income taxes. No doubt you expect me to present a long list of reasons why these various city income tax laws should be eliminated on the theory that we pay too many and too much taxes already.

Simplification of Tax Base

The first recommendation I would offer in an effort to simplify city income tax administration is that of a simple tax base.

1. When revenue needs are not great. If the need of a municipality for funds to supplement present revenues is not great, I would recommend the flat annual per capita tax of some nominal amount, such as five or ten dollars, as used by the city of Pittsburgh, Pennsylvania. This type of tax is easy to ad-

minister, particularly when keyed to residence. It is simple to understand, and its cost of administration is very low both to the city and to the employer.

2. *When revenue needs are great.* If the revenue needs of a city require a large amount of tax—large enough to make a flat tax inequitable to the lower income groups—then my first suggestion is that the tax be keyed entirely to residence and to the total earnings of the individual, regardless of where the work is performed.

In other words, do not allocate or prorate a nonresident's income among a number of cities based on the principle of where the work is performed. The reason for this recommendation ought to be obvious. As mentioned in the beginning of my talk, almost all of the expense of the city administration is due directly to the needs of the people living within the community. These needs run the gamut from providing education for the children all the way through all categories to spraying the town with DDT to eliminate flies and mosquitoes. The needs of the residents determine the amount of money the average community is required to spend.

There are, of course, a few exceptions to this general statement, particularly in our very large metropolitan centers, but those are not the cases we are concerned with today.

If the local tax is keyed to residence only and based on the entire earnings for each resident, regardless of where he works, the tax will more likely be related to the city's expenditures on behalf of the individual taxpayer than is true where a city attempts to reach the income of a nonresident.

Elimination of Withholding Tax Feature

The second important recommendation is to eliminate the withholding tax feature of city income tax laws. This is the expensive phase of city income tax administration from the employer's point of view, and I am sure it is important from the city's point of view also.

There are only two good reasons for adopting the plan of

withholding taxes at the source, and neither one seems to apply here.

1. The principle may very well be used when the tax to be collected is so large as to make payment a very real burden on the taxpayer. The outstanding example, of course, is the withholding principle as applied to federal income taxation. In the case of very large tax bills, collection of the tax was placed in jeopardy prior to adoption of the withholding tax principle.

This problem does not apply in the case of local city income taxes where the rates run up to only 1 per cent and the total amount of tax for an individual taxpayer in perhaps 90 per cent of the cases will not exceed $40 per year or not much more than seventy-five cents per week. Since this is very much less than the amount of the average real estate tax, it is obvious that the withholding tax feature is entirely unnecessary.

2. Most cities have ample means of controlling an income tax act based on the use of individual returns from the taxpayer. In fact, if individual tax return forms were patterned to fit the federal tax return, it would save the taxpayer the trouble of preparing another set of returns; and, the city would very likely by this power of suggestion receive an accurate return.

In so far as policing the returns is concerned, it should be remembered that the major objective should be to reach the permanent citizens in the town and not to worry too much about the floaters. If this is kept in mind, the city will have ample means to check on the filing of returns through polling lists, public utility records, water meters, telephone directories, and various other media.

Elimination of Information Returns

This brings me to the subject of information returns. I don't believe that cities should set up procedures which require information returns from employers. The cost of this type of administration is too high both for the employer and for the city. Furthermore, much of the vast amount of work done is completely wasted.

Only a small percentage of income tax returns need ever be verified. Such verification should be keyed to the principle of policing and keeping the public alive to the possibility of having their returns audited, rather than to a 100 per cent coverage of all returns.

In this thinking I am reminded of the very excellent administration of unemployment compensation accomplished by the state of Wisconsin. This state requires no detailed reporting of the employee's earnings by name. They only ask for salary information at the time the claim for actual unemployment compensation is filed. Based on our experience with unemployment compensation, the number of claims filed, compared with the total number of earnings reports prepared during 1947, was only 6 per cent. In other words, only six reports of earnings are required out of every one hundred which are prepared. This Wisconsin system saves the difference of 94 per cent. Cities and small towns can very well follow this very efficient example.

Elimination of Tax on Profits

Eliminate the tax on the profits of companies and corporations. As indicated previously this tax cannot be applied equitably and should, therefore, be dropped. The following examples will, I am sure, indicate the reasons why this type of local taxation should not be applied:

1. Jewel has its headquarters office and plant in the small town of Barrington, Illinois. This headquarters serves forty-three states or approximately fifteen thousand cities and towns in this country. The bulk of the company's property and the great majority of the company's personnel, however, are not located in Barrington and the area is unimportant so far as a sales outlet is concerned. Thus, any allocation of our company's profit to Barrington under any of the methods in general use would mean little to the community in the form of income tax despite the location of our headquarters in the town.
2. There is a small manufacturing plant just outside the limits of Barrington. No expense whatever is incurred by the village for this plant because of its location outside the village limits. On the other

hand all of the employees live in the village; and, of course, the village must provide these employees with facilities and services including fire protection, police, water, education, recreation, etc. In this case the village has the expense of serving the employees who work for the company, but it cannot tax the company's profits.

It would seem that a form of tangible property tax is the only one which may do the job for a small community with respect to business institutions. Wages and earnings taxes ought to be considered only with respect to individual wage earners, salaried employees, professional men, etc.

Conclusions

Perhaps I have oversimplified my recommendations for future income tax legislation. If so, it is because I am convinced that simplification is the answer. We must keep our costs down, both for our cities and for our companies. The more costs we load on companies the higher prices consumers will have to pay for their products. Our American way of life may best be preserved by continually producing a greater volume at a lower cost. It is as important to keep costs low in this respect as it is to increase volume.

My plea is for adequate income for our towns and villages but based on simple, easily understood, and low-cost administrative types of income ordinances.

In summary then, we come to these conclusions. The present type of local income tax withholding laws are subject to the following criticisms:

1. They are too difficult to apply in a large number of industries where the work of the employees is not localized in one town.
2. The cost of administration is too high relative to the amount of tax withheld.
3. There is no uniformity in the tax reporting periods.
4. There is no standardization of report forms.
5. The procedures of using detailed information returns by names, as set forth in the laws, are too complex and expensive to be practical.

Local income tax laws where required to supplement other forms of local taxation—

1. Should be based on residence and not on the place where work is performed and should not apply to nonresident employees.
2. Should not incorporate the withholding tax feature.
3. Should not require information returns of employers except upon a spot check of a small percentage of taxpayers.
4. Should not be applied to company and corporate profits.

You will notice that nowhere in these recommendations have I suggested a reduction in tax rates; however, I would not be true to my vocation if I did not suggest that a tax cut would be the kindest cut of all.

CHAPTER XL

HARMONIZING FEDERAL, STATE, AND LOCAL INCOME TAX ADMINISTRATION

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TO MOST PEOPLE tax administration is purely and simply a governmental operation. This view is naive; for example, in the taxation of income, tax administration is a process which though directed by government is in fact dependent on persons outside government for the execution of many of its tedious and detailed operations. In this discussion tax administration will be treated as divisible into two complementary elements, the governmental role, and the citizens' role in the process. It follows that the simplification of either of these elements will be beneficial to our national fiscal operations.

Before proceeding further a distinction should be taken between two often confused aspects of the problem of multiple taxation, that is between those defects which are incidental to the mere existence of many and diverse income tax laws and the cumulative burden of the taxes levied pursuant to those laws. The possibility that concurrent powers of taxation might beget multiple levies and heavier taxes was not unanticipated by the framers and expounders of the Constitution:

> It is, indeed, possible that a tax might be laid on a particular article by a State which might render it INEXPEDIENT that thus a further tax should be laid on the same article by the Union; but it would not imply a Constitutional inability to impose a further tax. The quantity of the imposition, the expediency or inexpediency of an increase on either side, would be mutually questions of prudence. . . .[1]

[1] *The Federalist,* No. XXXII.

But, ordinarily at least, the size of the combined tax bill, federal, state, and local, is determined by governmental expenditures, and this involves expenditure policy rather than tax policy.

Problems Arising from Multiple Taxation

It is unquestionable, however, that a multiplicity of taxes on the same subject matter has undesirable consequences: it complicates the doing of business; and it increases overhead costs of operations because the costs of tax compliance are higher. These effects are incidental in nature and it is this phase of multiple taxation which improved administration can render less burdensome.

The general criticisms attributed to the multiplicity of taxing jurisdictions and diversity of tax laws may be summed up under two headings: (1) excessive cost of compliance on the part of the taxpayer, and (2) excessive cost in terms of multiplied uncoordinated effort by the governments involved. The first involves what we have termed the citizen element and the second involves the governmental element of tax administration.

Excessive Costs of Compliance

Among specific items of complaint based on excessive cost of compliance to the taxpayer are (a) interruption of business routine by auditors of more than one jurisdiction; (b) time spent in searching files to support particular claims or to answer queries of tax auditors; (c) time spent in making out returns for various jurisdictions differing sufficiently among themselves that standard procedures or entries cannot be used for all of them, e.g., different treatment of rental, interest, dividends, capital gains, deductions; and (d) the allocation of income among taxing jurisdictions. These criticisms are, on the whole, recognized, and sporadic efforts have been made to eliminate them.

Excessive Administrative Costs

As to excessive administrative costs attributed to multiple but uncoordinated governmental activity, it is advisable to defer judgment on this point. It may well be that present expenditures for this purpose are not high enough. There is evidence that this is true [2] but it remains to be proved after an appraisal of requirements has been made and there has been an opportunity to judge whether the total force now employed by all governments involved can meet these requirements.

PROSPECTS FOR REDUCING ADMINISTRATIVE COSTS

Now to the gist of the problem. What is the prospect for reducing the citizens' administrative costs while maximizing the usefulness of existing governmental administrative staff?

Judged wholly on past performance, the prospects for a favorable answer to the first part of the question would be poor. It is a fact, however, that the state tax administrators are becoming more and more conscious of the cost of insubstantial differences in tax laws. Perhaps the quick growth of sales taxes has had more to do with this realization than any phase of income taxation. As local governments move into similar fields of taxation it is to be expected that their officials will be impressed by the same facts.

There is good reason to believe that the Uniform Income Tax Administration Committee of the National Association of Tax Administrators will give this matter much more consideration than heretofore although to be sure the committee does not go so far as to recommend the adoption of taxable federal income as the basis for state income taxes, personal and corporate.

The methods generally used for allocating business income among the several states have been criticized for both inconsistency and diversity, and have been the object of numerous

[2] As to the federal government see the report of the Committee on the Administration of the Internal Revenue.

studies or investigations. The resulting changes have not been so numerous as the studies; the tendency if, indeed, any can really be discerned, is toward the use of the three-factor formula of property, payroll, and sales. The Uniform Income Tax Administration Committee of the National Association of Tax Administrators favors this formula for general use.

Incidentally, these state income tax administrators, in an effort to do substantial justice in allocating interstate income, have provided for the exchange of data on income reported and income allocated by enterprises operating in more than one state. While the primary purpose of such a procedure is adequate enforcement of the income tax, the plan also has the advantage, and this has been a real consideration, that it would disclose any instances where more than 100 per cent of net income has been taxed. It is often argued that a diversity of allocation formulas might have the result of subjecting more than 100 per cent of income to tax; on the other hand tax administrators know that now and then a taxpayer operating in more than one state has managed to allocate the lion's share of the income to a nontaxing state.

This comparatively favorable attitude toward the elimination of insubstantial differences in state tax laws is encouraging. I venture to say, however, that the great pressure for amendments of this nature will come as a by-product of closer operating relationships between federal and state administrative staffs. This point will be developed later on in the discussion.

Improvement of Operating Relationships

We come now to the purely governmental role in income tax administration and consider what might be done to improve operating relationships among the staffs of the several jurisdictions involved, thus to avoid the criticism based on multiple uncoordinated enforcement activity.

The magnitude of the annual operating problem should not be underestimated. The federal income tax involves approximately 55,000,000 individual and 570,000 corporate returns

plus about 145,000,000 supplemental documents. Then there are about 8,000,000 taxable returns from individuals and something over 400,000 returns from corporations filed with the states, presumably with corresponding number of supplemental documents. To these figures should be added an undetermined number of returns to local governments.

Of the 55,000,000 federal individual returns 3.8 per cent receive some type of investigation. Of the 570,000 federal corporate returns about 25 per cent are verified. The terms "investigation" and "verification" are indefinite but the type of field work done on corporate returns is much more searching than the investigation made on the majority of individual income tax returns. In state administration the percentage of returns audited or investigated varies considerably, but hazarding a generalization on state practice compared to the federal figures just cited, it appears that a higher percentage of individual returns and a lower percentage of corporate returns are audited.

Utilization of Personnel and Information

At the present time there is no proposal with more potential success in coordinating administrative effort in the income tax field than that which involves a sensible division of the work so that all personnel and all information available will be fully used.

The enactment of legislation giving state officials access to federal income tax information might be regarded as the first step taken to eliminate waste motion. The value of this step has been demonstrated even though its operation on a nation-wide basis through the collectors' offices could be considerably improved. Why not apply the principle behind this legislation to all aspects of income tax administration?

The Bureau and the thirty-four states with income taxes conduct extensive field operations which may be divided roughly into investigations and audits of taxpayers. At the present time the interrelations of these field forces are haphazard. The Bureau investigates and audits as many taxpayers as time and

personnel permit. The state commissions do the same. Circumstances are such that the choice of subjects for investigation and audit is usually governed by the anticipated revenue to be gained from the operation or because the statute of limitations is about to become effective. It happens often that the same subjects are selected for this attention by both the Bureau and the states and it follows naturally that other classes of taxpayers go unchecked. Thus, some taxpayers suffer an undue loss of business time while, on the other hand, the failure to enforce the tax adequately as to all classes of taxpayers is a threat to the maintenance of good taxpayer morale.

A channelling of the several governments' administrative activities into a coordinated effort utilizing existing personnel and information to the fullest extent would probably necessitate the following:

1. Full exchange of rosters of taxpayers or assessment lists for the purpose of discovering omissions in filing or discrepancies in reporting net income.
2. Full and automatic exchange of data on any cases involving additional assessments. There are good indications that states have better coverage than the federal government on audits or investigations of individuals and small corporations simply because the United States has concentrated its activities on the returns with the higher incomes.
3. One audit of a taxpayer to serve the requirements of the federal government and any state interested.
4. Selection of cases on the basis of judgment informed by experience and by the analysis of field operations but including some percentage of audits based wholly on a sample taken at random.
5. Assignment of audit cases in such manner as to best utilize available staff. There is some indication that states are in a better position by reason of their knowledge of local conditions and circumstances to audit particular types of taxpayers, for example, farmers, medium-sized retailers, and tavern keepers.

What I have just suggested is not intended to provide an avenue for one-way traffic from Bureau files to the state commissions. It means rather to open new avenues where there are none now; to provide for the free flow of traffic in all directions not only between the United States and a particular state or

vice versa but among the states themselves where there is common interest in a taxpayer.

Progress Toward Uniformity

Differences in definitions of taxable net income among the several jurisdictions, differences in professional qualifications of staffs, differences among the states in allocating net income once it has been determined, are points from which it might be argued that the proposed division of work among field personnel is impractical. Surely those are difficulties which can be mitigated if not wholly overcome. Standards for personnel can be established; even if differences in allocation formulas persist we would have eliminated duplication of effort in establishing the net income taxable; as to the differences prevailing in the definition of net income, it should be emphasized that in so far as the investigation or audit discloses failure to file, understatement of receipts, overstatement of expenses, etc., the main purpose of the investigation has been served and it requires only an office operation to make the necessary adjustment to determine the taxable income for any jurisdiction concerned in the case.

Against the difficulties which may be anticipated, consider the goal which can be won: the optimum use of the administrative staffs of the jurisdictions concerned. It is worth repeating that the attainment of this goal could give us the type of coverage in the income tax field that is necessary for an adequate and impartial enforcement of the tax, namely, some type of random investigation or audit of all classes of taxpayers; a more complete coverage of cases selected for audit or investigation by various criteria; a specialized coverage in those areas, often neglected, where it is required.

The more effective use of personnel anticipated from some such arrangement as that proposed would bring about primarily an improvement of the governmental side of income tax administration, except in so far as multiple audits of the same taxpayer were eliminated. There is a probability, however, that continued cooperative administration would eventually influ-

ence the substance and the reporting requirements of the income tax laws of the jurisdictions involved, and have a tendency to eliminate existing differences in the definition of net income.

The case for uniform definitions has been ably and often presented, but proposals about uniformity as such simply do not excite legislatures. Amendments introduced for a particular purpose and sponsored by the tax administrator offer the best possibility for the elimination of insubstantial differences in tax laws, and it is this contact with genuine cooperative administration that will, if anything can, provide the administrator with the incentive to resolve these differences. This is not to say that all differences will be resolved. Personal exemptions may well differ permanently, for example, and the formulas for allocating business income among the states may never become uniform, but many existing differences are susceptible to revision and probably would be revised in the long run.

This discussion has been limited to income tax administration because the scope of the symposium is thus defined. It should be pointed out, however, that the vexations attributable to the multiplicity of income taxing jurisdictions will soon be, if they are not already, matched by those which flow from general and special sales taxes. Whereas an income tax return must be filed once a year a sales tax return is often due monthly. Differences in laws are quite prevalent. Consequently the measures urged to make the administration of income taxes better by using the field personnel with optimum effectiveness applies with equally great force to excises.

Local Income Tax Administration

Most of what has been said is in terms of the relationships between the substance and administration of the federal income tax and the various state income taxes. Nevertheless, everything that has been said is, on principle, equally applicable to local income taxes and what can be accomplished as between the United States and the state governments can also

be accomplished with cities, counties, or other taxing jurisdictions.

Local income taxes are comparatively new and if they generally become applicable to all types of income difficult administrative situations will be created. The adequate, impartial, and separate administration of local income taxes will cause an increase in the personnel required by the tax departments of the localities and the external administrative burden is going to increase correspondingly. These results follow naturally because of the relatively small size yet comparatively large number of potential enacting jurisdictions.

Purely from an administrative standpoint the alternative to such a development is limitation of local income taxes to those on earned income or to wages and salaries solely; but to meet the administrative difficulties involved in a genuine income tax by reducing the base to one on earned income or wages and salaries would lead directly into the political field where there is some likelihood that the final decision would be for outright repeal. At any rate the local income tax has yet to gain wide public acceptance. Nevertheless, where such a tax is maintained on income generally, every consideration that leads us to believe that federal and state administrative effort should be coordinated applies equally in the case of the local income tax.

PART EIGHT

THE TAXPAYER'S STAKE IN EFFICIENT TAX ADMINISTRATION

CHAPTER XLI

THE TAXPAYER'S STAKE IN EFFICIENT TAX ADMINISTRATION

CARL BARKER

Assistant to President, Shell Oil Company, and President, Tax Institute

I KNOW THAT self-praise is said to be half scandal, but we are drawing to the close of what in my opinion has been a fine and comprehensive symposium on tax administration.

For almost three days we have had a rare opportunity to hear expert discussions of every angle of the problem by "men who know taxes best."

With sincere apologies to F. E. Boone and all his competitors, we can say that L.S.M.F.T. may also be translated "Long Symposiums Mean Fairer Taxes."

From the viewpoint of the "average" man, it is no doubt quite fitting that almost the last subject on the program should cover "The Taxpayer's Stake in Efficient Tax Administration." In fact, I believe that it can be truthfully said that the taxpayer's problems and views are *always* considered last—and too often the *least*. Going one step further it could be logically contended that in the recent election campaigns, the tax consequences of many of the platform planks were not considered at all.

The Republican Pearl Harbor of November 2 may have caused some businessmen to hurry their preparations for good deep "storm cellars" but I noticed no particular increase in the number jumping from high windows. I doubt that we have reached the point where we should give up all hope. As a

matter of fact I venture to state that the tax outlook would have been very serious regardless of election results. But in view of all the publicity given to various proposals which may be thrown in the legislative hoppers next year, it might be well to review the political situation briefly.

The press and political commentators have expressed many good reasons for the upset. Of course, it is always easy for Saturday night quarterbacks to point out the mistakes that were made and explain why the results. I am inclined to believe that the real answer to the election may be that just too many people followed the advice of Mr. Dooley. You may remember that the character created by Finley Peter Dunne about the turn of the century put it this way:

> "I was saying Hinnisy," said Mr. Dooley, "whin a man gets to be my age, he ducks political meetin's and reads th' papers an' weighs th' evidence an' th' argymints—pro and con—an' makes up his mind ca'mly . . . an' then votes th' Dimmycratic ticket."

But no matter what the reason, the winners are taking over, for better or for worse, for richer or for poorer. To many business leaders and no doubt many corporation tax men, the result was a shock of cold water. Certain of a Dewey victory, they had looked forward to what they were wont to term a better business "climate."

They will recall the legislative programs presented to the Eightieth Congress which included various types of business and economic controls, the reimposition of the excess profits tax, and the vetoes on the tax reduction measures. They will study apprehensively the proposals for added Social Security benefits, greatly increased federal spending, and foreign expenditures including military lend-lease.

Perhaps all of those things which business fears may turn out to be as bad as the pessimistically inclined predict. But there is certainly no doubt as to how the voters felt about the candidates' economic proposals. They voted for what they wanted, not for something the economists and "experts" thought they

ought to want. Maybe they are just as foolish as the Oregonians who voted a $50 monthly old-age pension, with no provision to finance the payments and the strong possibility that payments required would bankrupt the state. Or perhaps they are like the voters of Louisiana who were apparently ready to accept the tremendous tax burdens levied by the 1948 legislature in order to enjoy the benefits promised by the forces of Governor Long.

I think the point that we tax men often overlook is that in a true democracy such things do happen. It does not mean that the average man is, as one of our so-called politicians once said, "too damned dumb to understand." It is much more likely that he has heard so many economic half-truths for so long that he no longer counts the cost, to himself, of all the beautiful things promised him.

Certainly from a tax standpoint there was not enough difference between the publicized programs of the two major parties to sway any considerable number of voters. I do not recall that any candidate had the Churchill courage to stress the "blood, toil, sweat, and tears" recipe that will be needed to keep this country solvent in the face of constantly mounting government costs. I, for one, heard no candidate promise that he would see that the worker gets back the same kind of Social Security dollar he paid in taxes in 1937. Instead the candidates of both parties advocated increased benefits (in fifty-cent dollars) which would require higher taxes, while at the same time they proposed other measures to keep living costs at high levels.

It may appear to many of you that I have gone far astray from my subject. I have not lost sight of our objective and have digressed only to point out the seriousness of conditions and to lay the groundwork for suggesting that we, as tax men, change our course.

For the past sixteen years we have operated under a new and different concept of the role of government. As I have tried to point out, we are faced with four years of legislation which will follow generally the same principles. We, as close

students of government, see many dangers in the program which the average man may not perceive. But as I view it, we cannot afford to blind ourselves to the fact that not only were the advocates of the program elected, but both parties' tax and fiscal platforms were cut from the same cloth.

Responsibilities of Tax Executives

If it is the will of the people that these programs be carried out, then I suggest that as tax men we stop crying crocodile tears over every tax increase when *we* know, better than anyone else, that more and more taxes are only the end result of more and more governmental wasting, giving, and spending; when we must admit indeed that under present conditions high taxes are not only inevitable but, maybe, desirable.

I propose instead that we adopt a new approach to our tax problems. I suggest that we become triple threaters so we can then attack these problems on three separate fronts.

1. As individual taxpayers and presumably intelligent citizens, we should lead the fight through educational channels for governmental economy and efficiency.

2. As members of business and tax groups we must strive continuously to educate the public, individually as well as collectively, on the economic consequences of a too-paternal government. I might add parenthetically that many of our best industry and business organizations do an excellent job of educating their own members. It is evident, however, that the economic facts of life either do not reach the general public, or are not presented in a manner that leads to conviction. Too many people still believe that "the man with the whiskers" is Santa Claus instead of Uncle Sam. Too few realize that the money that he distributes comes from an operation on their pocketbooks and not through delivery by a printing press stork.

3. Finally, as tax men, we must concentrate on the proper drafting of tax legislation, on adequate provisions for effective administration, and on the selection and training of competent administrators and their staffs.

I make the above proposal because I believe that many of the leaders in the tax field have attempted to spread their efforts too thin. They have gone into battle with the theory-drunk economists who have had so much influence on those charting the course of our ship of state, without any appreciable public support. They have spent a great deal of personal time and effort on various committees in appraising the government's fiscal requirements and contriving possible tax combinations that would balance such a budget, yet with favorable metropolitan press support these plans apparently never were seriously considered by the electorate. During the depression thirties, the war, and the postwar periods, tax plans have been developed for almost every conceivable condition. Arguments have been prepared for or against every practical, and a host of impractical, tax levies, and mountains of propaganda have been distributed which were favorable or unfavorable to the panaceas of the "do-gooders." It is true that little of these data and materials has been adequately "sold" to those who elect the men who pass our laws. It is all readily available, however, and I submit that in our role of tax experts this sales job is not our primary responsibility. Moreover, I see little need for tax experts to argue with legislators over an increase in the corporation income tax from 38 per cent to 45 per cent or 50 per cent; the doubling of a state sales tax; or another penny per gallon on the gasoline tax. I do believe that our specialized training and experience can be of maximum value to our employers and clients if we focus our efforts primarily on the achievement of competitive equity in all the tax legislation to which the electorate will submit.

Achievement of Equity Through Good Administration

I wonder if we all mean the same thing when we talk of tax equity. I am afraid equity to some taxpayers involves a little advantage over the other fellow—to some politicians, a most-favored-nation clause, so to speak, for one group or class.

Webster defines it as "equality of rights" or "the giving to each man his due according to the natural law."

The Doctors of Jurisprudence among you will recall that equity was also the system of law which originated in the extraordinary justice formerly administered by the king's chancellor, and was subsequently developed into a body of rules supplementary to and aiding the common or statute law. This surely can be likened to the mass of rules and regulations which have been developed to aid in a fair administration of tax law.

Looked at from this angle, the question of equity in our particular field is largely in the hands of the tax administrator. In short, it means that "the giving to each man his due" is the main responsibility of the administrator, and a grave and serious responsibility it is.

It is obvious to anyone who has closely followed the legislative course of tax measures that equity can be best attained through good administration. For example, we all know that the legislative intent of many tax law provisions is not clear. This results usually from compromises which are most easily achieved by vague or ambiguous phrases, instead of specific clear language. Moreover, many of the tax laws directly affecting the oil industry, for example, were drafted originally by those with little knowledge of the intricate problems involved. In such circumstances, the administrator has no alternative except to promulgate what he considers a fair and reasonable interpretation. The difficulties that naturally arise are traceable more to poor legislative drafting than to inefficient administration.

Since legislation and administration are so closely interwoven, we can hardly treat the one without also considering the other. In other words, the taxpayer cannot expect equity without both well-drafted legislation and efficient administration. The oil industry's experience in this matter may be of interest.

Experience of Oil Industry

Despite voluminous propaganda to the contrary, the oil industry is intensively competitive. Changes in cost or price of a fraction of a cent a gallon mean large sums in the aggregate when business is measured in hundreds of millions of gallons. Therefore, it behooves every company to maintain a competitive tax position, as well as worry about supplies, transportation, and sales.

Starting at the point with which the public is most familiar, the service station, it is obvious that if two otherwise comparable stations on opposite corners are assessed differently, the one with the lowest assessment has an unfair competitive advantage. I can assure you from long experience that such inequitable assessments are not rare, although there has been a great deal of improvement in this respect over the last twenty years. On the whole, though, I think we can say that better administration of property taxes can achieve equity for more taxpayers than in any other field. Business particularly can benefit, because in communities where ad valorem taxes are administered scientifically, the office handling of such taxes becomes a more or less routine procedure. At the risk of causing job insecurity for some good property tax men, I submit that business generally should favor the best assessment practices that have been developed and should assist in any campaign to put the local assessors in a strong civil service capacity, so that many more competent men may be attracted to the job.

Still at the municipal level, we might consider the oil industry's problem of the municipal gasoline tax. The taxpayer's stake in good administration here is much more serious. With tax rates reaching two cents a gallon, the unscrupulous dealer who evades the tax has a competitive advantage the law-abiding dealer cannot meet. And with the best intentions in the world, the administrator still is faced with almost insurmountable difficulties in attempting to collect this type of tax. Such a sales tax at the municipal level has to date proven to be impossible

of equitable administration. Consider if you will, just one of his problems. The "X" Oil Company with its bulk storage outside the city, has stations both outside the city limits where only the state tax applies and within, where both city and state levy a tax. Deliveries are made by the same trucks to both city and suburban locations. How is the city to collect all the taxes to which it is entitled? In Missouri, where municipal gasoline taxes have been widespread, the oil industry felt that the best practical method of avoiding these difficulties was to increase the state tax, share part of these taxes with counties and municipalities and abolish the local levy. This proposition, however, was voted down on November 2.

Before being called to account by anyone who feels that it is a mistake to talk about the oil industry as the taxpayer under a municipal gasoline tax ordinance, let me explain that from a practical standpoint, it is usually impossible to maintain a higher price in the city where a gallonage tax is levied, than immediately across the city line where there is no tax. As a result, the oil industry has often been forced to absorb the tax. It is not only the technical taxpayer, but also the actual taxpayer. As other types of business decentralize their metropolitan sales outlets, they will face the same problems in connection with municipal sales taxes. Only with the highest type of administration can business avoid the tax burdens as well as the compliance costs imposed by this type of levy.

State taxes require more administrative discretion than local levies, since most of them are more complicated. What are some of our problems at this level? The state motor fuel taxes may point up a few of them.

It seems that it should be a rather simple matter to levy and collect a tax on gasoline. There are probably many motorists who believe that it is only necessary to require the service station salesman to collect a few pennies on each gallon sold and remit the total to the state. Actually, as you know, the state normally receives the tax from the distributor or wholesaler who in many cases, has paid the money to the collector before

the motor fuel is used by the motorist. This procedure of collecting millions of tax dollars from a relatively small number of distributors, instead of a large number of retailers or a multitude of motorists, is quite convenient for the state. It poses many serious and costly problems for the taxpayer.

Our primary difficulties with this tax were the direct results of faulty legislative drafting. It is true that the administration in the early years also left much to be desired, but even after the administrators had "learned the ropes," they were severely handicapped by inadequate laws.

The first of these laws, which was enacted by Oregon some thirty years ago, was intended to provide funds for the maintenance of highways. Hence, it was contended in subsequent legislative debates that gasoline not used as motor fuel for highway purposes—consumed in airplanes, farm tractors, stationary engines, etc.—should not be taxed. Later, the situation was further complicated by the use of liquids other than gasoline as motor vehicle fuel, and the manufacture of many petroleum products for special purposes which had many of the characteristics of motor fuel, could under certain conditions be used to propel automobiles, but actually were not sold as motor fuel.

Two methods were used to eliminate the tax on motor fuels not used to propel motor vehicles on the highways. Some states adopted exemption provisions. Others required payment of the tax, but authorized refunds for non-highway use. Both methods led to abuses and were frequently the avenues of tax evasion. Increasing tax rates made evasion more and more profitable and even some tax officials became involved. Two of them committed suicide in 1936 during investigations of alleged conspiracies to defraud the states through manipulation of motor fuel tax refunds.

So far as I know, the industry's tax men did not feel called upon to commit hara-kiri during this period. Management, however, was deeply concerned because evasion had reached the point where it permitted wholesale price cutting, sometimes affecting the price structure over wide areas. In order to protect

his markets, the legitimate law-abiding distributor had to absorb most or all of the tax to meet the price competition of the evader, who paid none.

This condition, which was most serious during the economic depression following 1929, could not be permitted to continue. Special tax evasion committees were formed, and even private investigators were hired to find out how the evaders worked. As chairman of one of the state gas tax evasion committees, I gained firsthand knowledge of this sordid condition. I could recount for you all the various methods used, such as misbilling, product adulteration, forged refund claims, double sets of books, deliveries by tanks with false bottoms, and many of the tactics used by the old prohibition gangs of the Volstead era. Suffice it to say that the gas tax evaders missed few bets in their efforts to increase their ill-gotten gains.

Cooperation Between Taxpayers and Administrators

Knowing how the tax was being evaded was only half the battle. With the wholehearted cooperation of most of the administrators, steps were taken to increase administrative efficiency all along the line. Additional inspectors were hired and trained, accountants and auditors checked and double-checked all suspicious returns, reports, and claims. The state legal departments went into action, and many evaders caught in the net were tried and convicted.

Much good was accomplished, but it was obvious that in many states, effective control was impossible without amendments to the law. How the majority of these amendments were secured is a lesson in cooperation between taxpayers and administrators, which might well be taken to heart by many other groups.

Briefly, it involved nothing more new and startling than over-the-table conferences between those who paid the tax and those who levied and collected it. The industry's tax experts developed new and better definitions for taxable motor fuel, submitted ideas for improved reports and records, and even

went so far as to publicly recommend larger appropriations for the administrative agencies, so that adequate personnel could be hired and trained. The administrators offered many excellent ideas of their own to correct provisions which made it difficult for them to check returns and successfully prosecute those willfully violating the law. In give-and-take conferences, most disagreements over methods and procedure were ironed out and legislative bills were later prepared which both groups could support.

In the past sixteen years, the results have been extremely favorable to both the industry and the administrators. Gasoline tax evasion as a business is practically nonexistent, and under the systems now set up, it is extremely unlikely that it will ever again reach the damaging proportions of those early years. The administrator has benefited also, for most of them now operate under laws which have very few of the legal loopholes which formerly made his job anything but a pleasure.

There is still much to be accomplished and I readily admit that we have yet to create the taxpayer's Utopia. For example, no practical method has been found to attain by legislation that taxpayer honesty which would make it possible to collect all the tax on motor fuel sold for non-highway use. Some of it still finds its way into the family jalopy, but the newer refund laws are a great improvement over those of the past two decades. The motor fuel tax will probably never be collected 100 per cent on products other than gasoline, which dishonest motorists may use to propel their motor vehicles on the highways. But the enactment of fuel use taxes has reduced that type of evasion to a trickle.

Value to Industry of Efficient Administration

The point I want to emphasize is that the industry's experience with the motor fuel tax and its administration indicates not only the value of the cooperative approach to the problems involved, but the even greater value to the industry of having its tax experts spend their time on better administration, the

closing of tax loopholes, and the stopping of evasion rather than a continuous fight on tax rates. The important point to the industry is that the degree to which the tax can be passed on to the consumer corresponds very closely to the degree to which the tax is collected. If administration is lax, either because of the law or because of inefficient personnel and procedure, pressure increases for tax absorption. Now tax absorption is a direct out-of-pocket expense. Its effect on profit and loss is something that management can understand. Furthermore, it sets up a chain reaction because every cent of tax absorbed reduces the direct burden on the consumer and his interest in the tax rate takes a corresponding drop.

As a corollary, the more effectively the tax is administered, the greater is the impact of high rates on the consumer, and the more difficult it becomes to push those rates beyond a reasonable level. Therefore, the efforts of the tax experts to obtain well-drafted tax legislation and businesslike administration will pay off, not only in direct benefits to their principals, but also as an indirect deterrent to exorbitant rates.

The material I have just presented applies to a greater or less extent to all the important taxes, and particularly to the excises. I have emphasized only the one provision that has caused us the most obvious difficulty, but there are many others that affect industry generally, of which I am sure you are well aware. All of them can be improved if the tax men will make the solutions of these problems their number one goal.

The petroleum industry holds no copyright on the plans and methods it has used. Its experience has demonstrated that practical, workable, well-administrated taxes are not only possible, but are well worth the hard work necessary to secure the required legislation and administration. What its tax men have done on taxes peculiar to one industry, others can do for their own types of business.

May I stress again that all business can benefit by directing the tax man's energies into the field of administration. Let the economists, the professors, and the public relations experts lead

the campaign to educate the people on proper governmental fiscal policies and tax rates. The tax expert can best do his bit by concentrating on the job for which he is best fitted; namely, the maximum improvement of tax law and administration for the achievement of competitive equity.

Educational Role of Tax Institute

I have been speaking to you so far as a tax man. I should like to change my role and in closing, express my gratitude for the pleasure of serving you as President of the Tax Institute during 1948 and to offer a suggestion or two for the future. I do this with the thought in mind that our entire program may lead the public to the conclusion that we are unaware of the gravity of the general tax situation and underestimate the importance of the educational program needed to make our economic future more secure. Nothing could be further from the truth.

Taxes now take such a large percentage of national income, and the taxpayer's welfare is so consistently disregarded, that folks are losing faith in their ability to better themselves. We have only to read of conditions in other parts of the world today to know that such a loss of faith is a terrible thing. A restoration of that faith is one of the prime objectives of the Marshall Plan. Perhaps we should demand a "Taxpayer's Recovery Program," as well as a European Recovery Program. At any rate we are fast approaching the point where we can no longer sit back and hope that the right will prevail just because it is right. Personally I am inclined to put more faith in the old copybook maxim that "The Lord helps those who help themselves."

I am convinced that the Institute has the opportunity to do a vitally necessary job; a job that no organization has yet done effectively; a job which no other group is as well equipped to do. It is not, and should not be, an action organization. But unless its educational efforts, coupled with that of others, pro-

duce action in the electorate, it cannot continue to grow and justify its existence.

It is not an easy job that lies before us. No school teacher was ever popular with *all* the students and the Institute may not please all those it tries to educate. The successful teachers, however, gained a respect and influence in the community, which few other citizens could attain. I firmly believe the Tax Institute can secure like respect and influence if it follows the same course and methods.

Whether the years to come will be lighted by courage or darkened by fear depends to a great extent on the success of these educational campaigns.

PART NINE

INTERNATIONAL ASPECTS OF INCOME TAX ADMINISTRATION

The addresses presented in Part Nine were delivered at a Joint Session with the INTERNATIONAL FISCAL ASSOCIATION.

CHAPTER XLII

ADMINISTRATIVE ASPECTS OF INTERNATIONAL TAX CONVENTIONS FROM GOVERNMENT POINT OF VIEW

RAPHAEL SHERFY

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I APPRECIATE the invitation which you have so kindly extended to me to speak on one of the most important phases of our tax treaty program. My first introduction into tax treaty work was during the period when the convention between the United States and France, signed in Paris on October 18, 1946, was taken up for consideration by a subcommittee of the Senate Foreign Relations Committee. The numerous objections voiced in the course of the hearings before this subcommittee against the administrative provisions of that convention emphasize the importance attached by interested groups to such provisions, and suggest the propriety of pointing out not only the reasonableness of these provisions but the necessity of their inclusion in any broad and balanced tax arrangements between two contracting countries.

My appearance here today is somewhat in the nature of a substitution. Special Deputy Commissioner Eldon P. King was originally scheduled to speak but, in view of his pressing obligations connected with negotiations with Greece, Italy, and Ireland, from which he has just returned, I am pinch-hitting for him. Naturally, he would have explained in more practical detail the actual operations involved in complying with the administrative provisions of our conventions, since the Commissioner of Internal Revenue has been designated in most of

these conventions as the authority for their enforcement. However, I may be able to contribute something to this discussion by outlining objectively some considerations which seem to point to the necessity of combining in our double taxation conventions provisions relating both to elimination of double taxation and to administrative cooperation.

Automatic Information

A convention for the elimination of double taxation modifies sharply the application of the general provisions of the Internal Revenue laws in certain specified areas. An obvious example of this is the reduction or elimination of the withholding rates of tax otherwise applicable to fixed or determinable income flowing to nonresident alien individuals, or foreign corporations not engaged in trade or business in the United States through a permanent establishment. Certainly, if the tax is eliminated or materially reduced at the source in the United States, the income should be subjected to the proper tax by the country in which the recipient is resident. Otherwise, these items of income, in effect, may, in the absence of information in the hands of the latter country, be either exempted or granted a preferential rate and a special tax advantage would accrue to a small class of taxpayers. Manifestly such a result is inequitable to the other taxpayers not benefited by a double tax convention and may render a tax convention an avenue of tax avoidance.

In order to inform the other contracting party as to the items of income going out of the United States tax-free or at reduced rates, the conventions to which the United States is a party have, in general, provided that automatic information shall be supplied in these cases. Typically, Article 21 of the Convention between the United States and France, signed in Paris on July 25, 1939, provides, in part, as follows:

> .... the competent authorities of the United States of America will transmit to the competent authorities of France, as regards any person, corporation or other entity (other than a citizen, corporation or other entity of the

United States of America) having an address in France and deriving from sources within the United States of America rents, dividends, interest, royalties, income from trusts, wages, salaries, pensions, annuities or other fixed or determinable periodical income, the name and address of such person, corporation or other entity as well as the amount of such income.

. . . .

The information relating to each year will be transmitted as soon as possible after December 31.

Section 7.425 of Treasury Decision 5499, prescribing regulations under this convention, accordingly requires that the information return, Form 1042C, be forwarded each year to the French authorities. This form contains the name and addresses of persons—nonresident aliens as to the United States—in France deriving from sources within the United States income of the classes contained in Article 21. This is deemed to constitute compliance with the provisions of that Article.

I mention the French convention only as an example of a reasonable implementation of the administrative cooperation in this particular area. Taxpayers falling within this regime should pay their proper tax to one or the other government on these items of income. Our tax conventions have not used a standard provision for the authorization of automatic information exchange. General authorization for the exchange of information in the ordinary course is found in Article XX of the United Kingdom convention, Article XXI of the Netherlands convention, and Article XVII of the Danish convention. In the Canadian and Swedish conventions, the article under which automatic information is exchanged is outlined in more detail. However, the administrative practice is exactly the same in principle.

The information periodically collected by the United States with respect to persons with foreign fiscal addresses and deriving from sources within the United States dividends, interest, rents, royalties, and the like, is listed on Form 1042, which is prepared annually by corporations and other withholding agents in the United States who make the actual payments of

the income of the nature described. Upon such income the United States imposes a tax, generally at the rate of 30 per cent, which is withheld at the source and paid into the Treasury annually. Such tax is imposed under the Internal Revenue Code only upon nonresident aliens and nonresident foreign corporations not engaged in trade or business in the United States. Hence the names appearing on the withholding return Form 1042 are necessarily those only of such aliens and corporations. No such withholding takes place on such income derived by United States citizens and domestic corporations and hence, their names do not appear on such form.

By the reduction in the withholding rates on specified items of investment income going to alien residents of the other contracting party, a premium is placed on the value of establishing a residence in the other contracting country from a tax point of view. It is, therefore, essential to prevent residents in nontreaty countries from establishing fiscal addresses in treaty countries so as to obtain the advantageous withholding rates. Such preferential rates may well be realized by establishing a nominee, custodian, or agent in a treaty country for the mere collection of the income. In order to prevent this and to collect the proper amount of tax due in these cases under our Canadian treaty, Section 7.17 of Treasury Decision 5157 requires Form 1042 to be prepared annually by persons in Canada who receive for the account of any person—other than a resident of Canada or a corporation organized under the laws of Canada—fixed or determinable income which has been subjected to the lower treaty rate. These persons are not entitled to this lower rate. This Form 1042 is, in practice, annually forwarded to the Collector of Internal Revenue, Baltimore, Maryland, accompanied by the tax shown to be due in United States dollars.

A similar arrangement has been established in the United Kingdom in order to prevent nonentitled alien taxpayers from obtaining the reduced rate on dividends. If the recipient in the United Kingdom of the dividend is a nominee or agent through whom the dividend flows to a person not entitled to the reduced

rate of 15 per cent, the recipient in the United Kingdom must withhold an additional tax equivalent to 15 per cent of the gross dividend prior to diminution by the 15 per cent previously deducted in the United States. This requirement applies to fiduciaries and partnerships acting as a nominee or agent for an unentitled person. The amounts so withheld must be turned into the Board of Inland Revenue which remits these amounts to the Collector of Internal Revenue, Baltimore, Maryland.

The above administrative cooperation between the United States on one hand, and Canada and the United Kingdom on the other, is one which is wholly reasonable to protect the United States Government from misuse of the bilateral treaties. It would appear that there can be no doubt as to the desirability of forestalling possibilities of using these conventions to evade our tax laws.

Specific Information

The foregoing discussion illustrates that automatic information is confined to aliens and foreign corporations with addresses in the other contracting country. Information which may be supplied in specific cases on request is quite a different subject.

In all of our treaties there is a general article which grants authority for each of the contracting governments to exchange information within certain limitations. Article XX of the United Kingdom convention is an example. Information available under the respective taxation laws of the contracting parties shall be exchanged to the extent necessary to carry out the provisions of the convention or for the prevention of fraud or the administration of statutory provisions against legal avoidance. It is specifically provided therein that "any information so exchanged shall be treated as secret and shall not be disclosed to any person other than those concerned with the assessment and collection of the taxes which are the subject of the Convention." Disclosure of any trade secret or process is strictly prohibited. Similarly in the Swedish convention author-

ity is granted in Article XVIII to each contracting party to obtain from the other particulars in concrete cases relative to the application of the taxes subject of the convention to citizens or to corporations or other entities of the party making the application. Either party may send information about its own citizens and corporations but it is not mandatory. Article XIX of the Swedish convention confines the obligation to exchange information to that which is consistent with the regulation and practice of both contracting parties and which can be procurable under the laws of both parties. To the same effect are Articles XVII and XIX of the Danish convention; Articles XXI and XXIII of the Netherlands convention; and Articles 22 and 24 of the French convention of 1939.

In all the cited treaties each country agrees to supply the other information on request of such other country. The language employed in the treaty with the United Kingdom (Article XX) is mandatory, while that employed in the treaty with Canada (Article XXI) is permissive and neither treaty contains any provision with regard to nationality. The language employed in the treaty with Sweden (Article XVIII) is mandatory with respect to citizens, corporations, or other entities of the requesting State, but optional in other cases, while the language employed in the treaty with France (Article 22) is mandatory in all cases except that it is made permissive with respect to citizens, corporations, or other entities of the State to which application is made if for the purpose of preventing fiscal evasion. The information so supplied is intended to reach those cases not covered by the automatic information, especially cases involving allocation of business income, and other cases where the automatic information is not sufficient.

Experience has shown, however, that the indirect benefits of this and other administrative provisions are greater than the direct benefits; that is, where one country has authority to request information from another country with respect to a taxpayer in the latter country, such a taxpayer will normally supply the information without need for such request. Simi-

larly, the taxpayer in one country will normally discuss terms of payment of the tax owing to the other if such other country has the right to make request for enforcement of its tax on the country in which the taxpayer is situated.

Administrative provisions are not included in treaties just for their own sake. They are designed to aid the efficient handling of treaty problems. This phase is explored quite thoroughly in the course of the negotiations and an understanding reached as to their practical operation. It has been shown from experience that governments do not use such provisions as a means of embarking on "fishing expeditions" for seeking random information, but that any request is solely grounded by reference to the identity of the taxpayer, the facts showing the necessity for the information sought, the absence of sources of information within the requesting country, and all other factors supporting the legitimate nature of the request. I understand from Mr. King that there has never been a case of a country requesting blanket information on all individuals or business enterprises entering into or investing in the other. This clearly would not be desirable. Inquiries in concrete cases invariably refer to specific matters involved in the audit or other investigations of a case in the other country.

With respect to those provisions of the convention relating to disclosure of information in specific cases, consideration is being given to the formulation of regulations directed towards a statement of fundamentals of procedure to the end that the taxpayers and others concerned will be appropriately advised of such modes of procedure, having in mind that such modes of procedure will conform in each case to United States domestic principles in this regard.

There is one aspect of this subject which seems to be continually overlooked and that is that taxpayers benefit in many cases from the authority to exchange information. As typified by Article XX of the Danish treaty, a taxpayer is permitted under all of our treaties to lodge a claim to prevent double taxation. Article XX provides:

Where a taxpayer shows proof that the action of the revenue authorities of the contracting States has resulted in double taxation in his case in respect of any taxes to which the present Convention relates, he shall be entitled to lodge a claim with the State of which he is a citizen or, if he is not a citizen of either of the contracting States, of the State of which he is a resident or, if the taxpayer is a corporation or other entity, with the State in which it is created or organized. Should the claim be upheld, the competent authority of such State may come to an agreement with the competent authority of the other State with a view to equitable avoidance of double taxation.

In the practical administration of this general type of provision it is necessary to exchange information with the other party in order to settle the ultimate controversy or claim. Without authority to give the other party the information upon which the United States acted it would be difficult to come to an agreement for the elimination of double taxation. A typical example may be the correct allocation of profits between a branch in Canada and its home office in the United States. If both countries tax the industrial and commercial profits of a branch on the theory that they arose in each of such countries, something should be done. This requires an exchange of views and information between the two governments before a common meeting point can be agreed upon. It certainly is necessary to be authorized to divulge information in this area both from the taxpayer's point of view and that of the two governments. Another example might be the case of proving to the other contracting party actual expenses allocable to a permanent establishment therein. The establishment by a convention of a forum for the discussion of tax problems by the revenue authorities of the two countries is one of the most desirable aspects of such arrangements, and one insuring to the taxpayers of both countries a full consideration of their problems.

I do not want to stress only the advantage of exchange of information to the taxpayer. The government, itself, is aided materially in case of tax evasion crossing international boundaries by being able to ask the particular foreign government

involved for relevant information. It would appear that this is a justifiable situation to request assistance. Certainly no one can condone the action of a taxpayer in deliberately evading his just tax liability and reasonable administrative cooperation aids the apprehending of these cases.

The foregoing is just a brief outline of the administrative cooperation necessitated by specific relief provisions of a double taxation convention. However, in addition, there should be sufficient authority in the convention to provide reasonable administrative cooperation to insure the collection of taxes properly and legally due the United States and the contracting governments with which it has treaties. It is highly important that treaties do not become avenues of tax evasion.

Collection

One of the most contentious points involved in the treaty program has been the provisions for mutual assistance in collection. By this is meant an agreement between the United States and the other contracting country to assist each other in the collection of taxes which are justly due, but which one of them is not able to collect because, for example, the taxpayer and his assets are beyond its jurisdiction and in the jurisdiction of the other.

The first provision of this kind to ever appear in a treaty in which the United States was a party is the United States-Sweden convention, signed at Washington in 1939. Article XVII of that treaty provides, in part, that "each contracting State undertakes, in the case of citizens or corporations or other entity of the other contracting State, to lend assistance and support in the collection of taxes to which the present convention relates. . . ." As you will observe, this convention draws what has been generally referred to as "lines of nationality." In other words, Sweden has agreed to collect United States tax due from citizens or corporations or other entities of the United States. A similar provision is contained in Article 23 of the French convention of 1939, Article 18 of the Danish

convention, and Article XXII of the Netherlands convention. In the French convention of 1946, agreement was reached for mutual collection between France and the United States, but with no "lines of nationality" drawn. Much criticism was leveled against this provision when the convention was under consideration by the subcommittee of the Senate Foreign Relations Committee and the final result was that a protocol to the 1946 convention provided that collection must be restricted by "lines of nationality."

It is fundamental in the present United States tax system that income taxes are imposed on the earnings and profits of citizens and corporations abroad, with very limited exceptions. When a taxpayer is outside the jurisdiction of the United States it is impossible to enforce the collection of his justly due taxes unless he has assets in this country. In the past few years, numerous requests have been sent to delinquent taxpayers requesting them to pay their tax obligations to the United States government. These requests go to the consulates of the United States all over the world. It is unfortunate that no effective enforcement procedures can be taken against taxpayers resident abroad in order to collect their properly due income tax liabilities. For this reason, it would appear desirable that a collection provision should be a part of our tax conventions, at least to the extent that the United States may obtain the assistance of the other contracting party in collecting the federal income tax liabilities due from its own citizens, corporations, or other entities.

CHAPTER XLIII

ADMINISTRATIVE ASPECTS OF INTERNATIONAL TAX CONVENTIONS FROM TAXPAYER POINT OF VIEW

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IN DEALING with the administrative aspects of international tax conventions from the governmental point of view, Mr. Sherfy of the Treasury Department has covered:

1. The automatic exchange of information;
2. The supplying of information in response to a specific request; and
3. Mutual assistance in the collection of taxes.

The same order will be followed in reflecting the taxpayers' views on these subjects. By way of a general introduction it may be said that the attitude of the business community has been consistently based on the proposition that the primary purpose of tax conventions should be the elimination of international double taxation, and that administrative assistance should be reduced to the minimum necessary to carry out relief provisions.

Tax conventions dedicated to the promotion of trade, through the removal of the barriers and burdens resulting from the duplication of the levies of two states on the same income or property, should not be utilized to reach capital or property that frightened residents of a given country have in the past placed abroad for reasons of safety. The long-established right of political sanctuary for persons should be extended equally to their property, lest we find this government in the ridiculous

situation where it would grant political sanctuary to a refugee from a foreign country, yet yield his property to the government from which he has fled, with the result that he might be left destitute and a public charge in this country where safety was sought.

Moreover, under the guise of promoting international trade, governments should not seek in tax conventions the means of enforcing principles of taxation that are inhibitory to such trade.

Ever since the early nineteen twenties, when the technical committees of the League of Nations began their studies of the elimination of international double taxation, the taxpayer has advocated the limitation of tax treaties to the avoidance of international double taxation, and the League committees dealt with administrative assistance in model conventions which were quite separate and distinct from those to prevent the overlapping claims of states. During the more than two decades of development of international tax law under the aegis of the former world organization, the taxpayer was represented by the International Chamber of Commerce. While that body may still speak for him before the Fiscal Commission of the United Nations, his voice has also been echoed in Tax Congresses held in Europe by the International Fiscal Association, and in the United States by the National Foreign Trade Council. It is primarily the views of the Tax Committee of the last-mentioned organization that are set forth in some detail in this paper. In substance all of these organizations contend that once the burdens of duplicate taxation have been eliminated on a sound basis, the administration of a tax treaty should be no more difficult than the enforcement of the law of the respective countries, and the great majority of taxpayers would not be tempted to evade tax liability.

Nevertheless, certain authorities have been said to want the assistance of other governments not so much to implement relief provisions in treaties but to reach income from or even the capital which residents of the country have placed in safe-

keeping abroad so that they would have something to live on in the event they themselves might have to seek refuge abroad because of adverse political developments at home. While this second aspect is seldom if ever mentioned in official documents, its importance cannot be overlooked in trying to understand some of the stringent treaty provisions on the one hand, and the taxpayers' strong opposition thereto on the other.

At the outset mutual assistance provisions were generally incorporated in a convention separate from that in which double tax relief was provided, but in recent years the tendency has been to incorporate both in the same convention. Sometimes a convention to assure long-wanted relief for international business is delayed because of one government not being willing to go as far as the other insists it should go in according assistance. The former may not have any existing method of supplying the information the other government wants or may be loathe to violate long-existing principles of banking or trade secrecy, or to open its courts to the enforcement of foreign tax claims.

In short, a government may fear that stringent articles on mutual assistance may frighten away the business and investments it wants to attract to its territory. Its negotiators know that even the most conscientious taxpayers may be unwilling to add to the risks of doing business in a foreign country the danger of having their own government give to the other government information or assistance in enforcing a claim that may be erroneous or arbitrary.

Instead of being the beneficiary of a relief provision under which no question of tax evasion may be involved, the taxpayer fears he may be unjustifiably made the victim of a measure intended to aid in recapturing refugee capital or to punish an evasion of pre-treaty liabilities. Hitherto, he has not even been assured a hearing by his own government before it responds to a request for information which it has obtained from him under a guarantee of secrecy. Moreover, if his government undertakes to enforce a final judgment of a foreign court against

him, he will presumably have no opportunity for a hearing in his home courts on the merits of the assessment under the foreign law. Consequently no amount of soothing assurance on the part of the officials of his own government that the provisions are designed to catch only the occasional tax evader will allay his apprehensions.

Hence, the more commitments a government makes to assist the other government, the more it tends to nullify the substantive provisions in the treaty to encourage the flow of trade and capital.

Let us see what is the minimum of assistance provisions that might be adopted to implement the relief provisions without subjecting the taxpayer of good faith to unnecessary risks.

Automatic Exchange of Information

Mr. Sherfy's first main point was that if a tax convention provides for relief from double taxation in the form of a reduction or exemption from tax in the country of source, then the parties to the convention must make sure that the income will be subject to the proper tax in the country of residence of the taxpayer. Otherwise the tax convention may serve as an avenue of tax avoidance.

The types of income to which the previous speaker alludes are primarily dividends, interest and royalties on patents, copyrights, and similar rights.

Dividends

Problems may arise in connection with treaty provisions for avoiding double taxation of dividends. This is especially likely if one country agrees to a reduction in the rate of tax it withholds from dividends, as the recipient of the dividend in the other contracting state may fail to report such income for purposes of tax liability in that state.

When one contracting state reduces its tax rate applied to dividends paid to residents of a second contracting state, these two states may also wish to prevent a person resident in a third

state, who holds shares in a company in the first state, from improperly obtaining the benefit of the reduced rate by receiving the dividends through a nominee resident in the second state.

Many of the European states have a so-called schedular tax on dividends in addition to the tax on profits payable by the company. Some states, notably France, also subject to the schedular tax dividends received from abroad by residents. Some European countries impose a progressive tax on the entire net income of persons habitually resident in their territory. The country of source is not concerned with what happens to dividends paid to nonresidents after the schedular tax has been withheld, but a country which subjects dividends received from abroad by residents to its schedular tax or progressive personal tax is concerned with preventing the evasion of such levies. France in particular has made repeated efforts to get other countries to give information as to the amount of such income from abroad paid to its residents.

In its tax convention with the United States, France allows a reduction in its rate of schedular tax on dividends from the United States.[1] The relief from double taxation so provided is incomplete and only recently has France eliminated its discriminatory high rate on income from foreign securities. France may therefore now feel that the taxpayer cannot object to the government receiving information about his income from United States sources taxable at the rate of 30 per cent in the United States and also subject in France to a part of the schedular tax and inclusion in the income subject to the personal tax on global income. The taxpayer will recall, however, that France has asked the assistance of other governments to reach the income from capital, and perhaps the capital itself, which had sought security in the United States or other countries before the convention of 1939, containing mutual assistance provisions, was concluded. Therefore the fear of penalties for pre-

[1] Convention and Protocol between the United States of America and France of July 25, 1939, effective January 1, 1945, Convention Title I, Art. 14 (B).

treaty violations of tax laws resulting from precautionary measures of safety destroys any feeling on the part of the taxpayer in such a situation that the treaty is a blessing.

In contrast to the situation in France, the United States has since 1918 allowed a credit against its tax in respect of tax paid abroad on dividends and other income.[2] The credit so allowed covers the foreign rate in full if such rate is not in excess of the United States rate.

The Treasury has not to my knowledge reported that there exist many cases of tax evasion on the part of resident taxpayers deriving income from foreign sources.

From the viewpoint of the American citizen, resident, or corporation entitled to a credit for foreign taxes on dividends, the only administrative problem involved in this connection is submitting information to show that the foreign tax is allowable as a credit under Section 131, I.R.C., and obtaining from the foreign tax administration a receipt showing the payment of the foreign tax and the amount of income involved.

Generally speaking, countries have refused in tax conventions to forego the collection of their general withholding rate on dividends and interest from domestic sources payable to residents of other states. In such a case, the country of source is not dependent on the assistance of the other state to collect its tax. However, the country of residence may benefit by receiving information from the country of source as to dividends and interest paid to its residents, and the question arises whether such information should be given if the country of residence does not grant a sufficient allowance against its tax on residents to avoid double taxation.

Interest

The problems in regard to interest are essentially the same as those regarding dividends, especially when interest payable on bonds and other forms of indebtedness is subject to taxation by withholding at source. However, under the laws of various

[2] Internal Revenue Code, Sec. 131.

countries, interest on ordinary bank loans, especially if they are for less than a year, or unsecured loans to individual or corporate debtors are not always subject to withholding at source and are sometimes in principle taxable in the hands of the creditor at his residence. Naturally, if such loans are made across frontiers, there is a chance of their escaping tax in the country of the creditor through the creditor's failure to declare the income. However, the amount of such international lending has evidently not been considered sufficiently important to receive particular attention in tax conventions.

In the tax conventions concluded in recent years by the United States with the United Kingdom, The Netherlands, and Denmark, these countries have sought to encourage the inflow of private capital by granting an exemption in connection with interest paid by local debtors to creditors in the United States, who are not engaged in business in the state of the debtor.[3] Information is supplied in order to assure the payment of the tax due in the country where the creditor resides.[4] In addition, the countries signing the convention may be expected to prevent residents of third countries from obtaining the exemption by collecting interest from sources in the first country through a nominee resident in the second country.

Royalties

In various European countries the general principle with respect to the taxation of patent and copyright royalties has been that such amounts should be treated as income from a

[3] Convention between the United States of America and the United Kingdom of April 16, 1945, Art. VII; Convention between the United States of America and the Kingdom of The Netherlands of April 29, 1948, Art. VIII; and Convention between the United States of America and Denmark of May 6, 1948, Art. VII.

[4] In furtherance of the principle of reciprocal administrative assistance Regulations issued in connection with treaties entered into by the U.S. provide that every withholding agent shall make and file with the Collector of Internal Revenue an annual withholding return Form 1042 and in addition an information return showing all income received by nonresidents from U.S. sources, (T.D. 5206, sec. 7.37; T.D. 5569, sec. 7.530; T.D. 4975, sec. 25.15; T.D. 5499, sec. 7.425). The returns so filed are to be forwarded by the Sec. of the Treasury to the designated Minister in the foreign country (T.D. 5206, sec. 7.38; T.D. 5499, sec. 7.425 (b); T.D. 4975, sec. 25.16 (a); T.D. 5569, sec. 7.531).

liberal profession and therefore taxable where the owner of the patent or copyright resides. This general principle has been embodied in numerous European tax conventions, and also in the convention concluded by the United States with Sweden.[5] However, in subsequent tax conventions to which the United States has been a party, royalty income has been subjected to the same rule as that applied to business enterprises when the copyrights, patents, or similar rights are exploited by a business enterprise of one country having a permanent establishment in the other country,[6] or engaged in trade or business therein.[7] Some European treaties also embody similar qualifications to the rule of reciprocal exemption.

Obviously, if a country of source is interested in receiving the benefits of foreign technical knowledge and therefore grants an exemption for royalties paid to nonresidents, it has no concern if the recipient in the other country fails to declare such income.

However, if a treaty provides for reciprocal exemption of such income, it is not unusual to agree on measures to assure that the income exempt at source will be included in the taxable income of the recipient in his country of residence.[8]

Nature of Information Automatically Exchanged

At this point, let us consider the type of information that might be automatically exchanged to implement the above relief measures. Few foreign countries have developed any system of information at source that is in any way comparable to that obtained by the United States on Form 1042 showing dividends, interest, and other payments to nonresident aliens or foreign corporations which are subject to withholding. In many foreign countries stocks and bonds are generally in

[5] Convention between the United States of America and Sweden of March 23, 1939, Art. VI.

[6] Convention with Denmark, *supra*, Art. VIII; Convention with France, *supra*, Title I, Art. 7; Convention with The Netherlands, *supra*, Art. IX.

[7] Convention with the United Kingdom, *supra*, Art. VIII.

[8] The provisions enacted with respect to interest paid to nonresidents covered by the tax conventions and outlined in footnote 4 also apply to royalty payments.

bearer form and the tax system of the country often takes this fact into account in the rates withheld at the source. Hence, there can be little if any information available about American holders of such securities that can be sent to Washington. The very serious question arises whether the United States should agree to ship in bulk all the information it receives, from domestic withholding agents about amounts paid to residents of such countries, to the foreign administrations without receiving in return any equivalent amount of useful information.

Nevertheless, the United States Treasury has adopted this method of giving the other country information shown on Form 1042 about persons having an address in the latter's territory. Assuming a foreign country may have some information forms to supply in return, imagine the difficulties our officials are likely to have in translating the information into English and collating it for use in verifying the returns of taxpayers in this country. It is obvious that if a resident wished to evade the American tax he would simply receive his dividends or interest via a nontreaty country. As practically every American taxpayer will claim credit under Section 131, I.R.C., for any tax paid abroad and supply on his own initiative the information necessary to justify the credit, the information sent by the foreign government directly to the Treasury can hardly serve a very useful purpose.

In respect of income exempt at source, such as interest and royalties under certain conventions, the United States has adopted a more practical method. The person in one country who is entitled to the exemption in the other is required to submit a letter or form to the withholding agent, a copy of which is sent to the tax authorities to show that he is entitled to the exemption and the income is then paid without deduction of tax. A copy of this form may be forwarded to the administration of the country where the taxpayer resides.[9]

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[9] Reference to regulations, e.g., Regulations, Convention with France, 1939, T.D. 5499, sec. 7.418; convention with United Kingdom, T.D. 5569, sec. 7.532; claims, etc. and T.D. 5532, sec. 7.502 and 7.503.

It is urged that this method is the proper approach to supplying information to prevent a tax relief measure from becoming an avenue of tax avoidance. Let the resident in one country who wishes to enjoy a reduction in rate or exemption granted by the other country fill out a form in triplicate showing that he is entitled to the relief and send one copy to his own tax administration and two copies to the withholding agent in the other country, who will then forward one of them with his information return to the tax administration of the latter country.

Thus the apprehensions of the Treasuries of both countries can be allayed and the purpose of a relief provision can be realized with a minimum of trouble to the tax authorities as well as to the taxpayer. This simple procedure can be adapted to cases where securities are held on a long-term or short-term basis, and it is believed that the Treasury authorities can easily work out these details in regulations.

Information in Specific Cases

The clauses on mutual assistance that taxpayers have feared foreign tax authorities may use for unwarranted "fishing expeditions" are those committing the United States to supply information requested in specific cases. These may be subject to general limitations under which the United States may refuse to supply information not available under its laws or which would violate a trade secret or practice, but the failure of regulations to clarify these commitments has not served to reassure the American taxpayer.

The view has been expressed in hearings at Washington that if a foreign government asks for information from the Treasury with respect to one of its nationals who may happen to be in the United States, the Treasury should be free to supply that information without giving the taxpayer any previous notice. Apparently the same thing might happen if the person concerned were an American national.

Representatives of taxpayers feel it is only fair for the United

States to subject such a request to certain conditions, which should include, *inter alia:*

1. That the foreign government should show that the information sought is not available within its own jurisdiction, and that the information is essential to the collection of a tax claim which is prima facie justified; and
2. That the taxpayer should be given a hearing before the information is supplied.

In other words, the taxpayer should be believed to be innocent by our government until the other government actually shows, after he has had a chance to speak for himself, that he is guilty of an evasion. If our government acts on its own to supply the information without calling in the taxpayer, how is it to know that the information supplied would not violate a trade secret or practice or otherwise infringe a safeguard stipulated in the treaty.

Moreover, the cooperation of the taxpayer can probably facilitate the solution of any problem incident to applying basic principles of liability, or the allocation of income to sources within the country making the request.

Perhaps the foreign country is requesting information about manufacturing costs of a United States company which sells through a permanent establishment in the foreign country. Suppose the official in the Treasury gleans this information from the taxpayer's returns—there is still the very important question of the proper apportionment of the income between the manufacturing establishment in the United States and the sales establishment in the foreign country. It is hard to see how the proper apportionment can be computed without the cooperation of the taxpayer.

Business Income

Ever since representatives of the American government or its taxpayers began, soon after World War I, to cooperate in the movement to avoid international double taxation, emphasis has been placed on developing practical principles for the alloca-

tion of business income to sources in the various countries in which an enterprise carries on productive activities so as to obviate the need for the interested tax administrations to get together to cut the annual pie of net profit. The basic principle adopted after a world-wide survey of tax systems and practices is that the enterprise of one country should be taxable in the other country in respect of business income only to the extent that such income is allocable to a permanent establishment situated in the territory of the latter.[10] This term, "permanent establishment," has been defined in most tax conventions to include any kind of fixed or lasting installation of the enterprise such as a branch, factory, assembly plant, agricultural plantation, a mine or oil well. However, for the purpose of encouraging the flow of trade, and to obviate the obstructive effects of attempting to impose tax in cases where it is difficult to reach the taxpayer or to determine the amount of income attributable to a country concerned, there have been excluded from the definition of "permanent establishment" (1) dealings through a bona fide commission agent, broker, or custodian; (2) dealings through an agent not empowered regularly to conclude contracts or to deliver goods from a locally maintained stock; (3) mere purchasing activities; and (4) a subsidiary corporation.[11]

In order to preclude difficulties in determining the income allocable to the permanent establishment in one contracting state of an enterprise having its head office in the other contracting state, the Fiscal Committee of the League of Nations adopted the principle—and it is now a basic provision in prac-

[10] Draft Convention for the Allocation of Business Income between States for the purposes of taxation Annex, Reports of the Fiscal Committee to the Council of the League of Nations, June 26, 1933, and June 17, 1935; based on recommendations in Vol. IV on Methods of Allocating Taxable Income of Taxation of Foreign and National Enterprises, Vols. I-V, published by the League of Nations, Geneva, 1932 and 1933.

[11] Convention and Protocol between the United States of America and Canada of March 4, 1942, Protocol, sec. 3 (f); Convention with Denmark, *supra*, Art. II (1) (c); Convention and Protocol with France, *supra*, Protocol, Art. III (a); Convention with The Netherlands, *supra*, Art. II (i); Convention and Protocol with Sweden, *supra*, Protocol, sec. 1 (a); Convention with the United Kingdom, *supra*, Art. II (1).

tically all general conventions concerning income taxes—that the income attributed to such permanent establishment should be the amount it would derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions. This presupposes the maintenance of separate accounts to show the earnings of the establishment based on prices or charges made between the local establishment and other establishments of the enterprise, which prices or charges should correspond to those which would have been made with an independent third enterprise. The League of Nations Fiscal Committee and parties to tax treaties have recognized that an appropriate procedure for verifying the accounts of such an enterprise is to make a comparison with the profits realized by similarly circumstanced independent enterprises in the same country.

This principle of separate accounting was advocated most earnestly over a period of years by members of the International Chamber of Commerce and governments interested in developing their business abroad. They were definitely opposed to the so-called system of "fractional apportionment," of which Spain is the most outstanding exponent. That country met with difficulties in determining the profits attributable to branches in its territory of enterprises having their head offices abroad. Spain therefore developed the system of requiring the foreign enterprises to submit data to a "profits jury," which determines a relative percentage (*cifra relativa*) reflecting the importance of the Spanish business to the entire business of the foreign enterprise. This figure is generally applied for a period of three years, and is the measure used in determining the taxable proportion not only of the profits of the foreign company but also of the dividends paid at the head office abroad.

Clearly, if all the countries in which an American corporation carried on business insisted upon determining their taxes by such empirical method, the total of the assessments might in most cases exceed the entire net income of the American company. Moreover, the taxpayer could be subjected to the in-

tolerable burden of having to prepare its accounts in the language of the various foreign countries in which it was being assessed, and adjust its accounts to their respective accounting practices.

The advocates of the principle of separate accounting contended that, if the local establishment kept its accounts on an "arm's-length" basis in its relations with the rest of the enterprise, and if the local authorities could verify the accounts by a comparison with similar local independent enterprises, there would be no need for asking for the accounts of the head office. In addition, there would be no need to ask for the assistance of the tax administration of the state in which the head office was situated in arriving at a determination of tax liability. If the taxpayer felt that the income claimed by the local administration was more than that properly attributable to the branch, he could probably obtain a fair determination of the profits through negotiations with the local authorities, or if necessary by appealing to an administrative tribunal or the courts of the country. Fortunately, the principle of separate accounting has progressively won over that of fractional apportionment and has been incorporated in all our income tax conventions, with the result that administrative problems have been largely obviated.[12] However, the United States may conclude treaties with countries which may nevertheless seek to reach profits of the American enterprise not shown in the books of the local establishment, and the Treasury should never respond to such a request without first giving the taxpayer a chance to explain the situation. Often foreign tax laws provide for taxing all income realized on selling within the country goods produced abroad, or on selling abroad raw materials or other goods produced within the country, and there may be honest differences of opinion as to the amount of income a permanent establish-

[12] Convention and Protocol with Canada, *supra,* Convention, Art. III; Convention with Denmark, *supra,* Art. III (3); Convention and Protocol with France, *supra,* Title I, Art. 5; Convention with The Netherlands, *supra,* Art. III (2); Convention and Protocol with Sweden, *supra,* Art. III; Convention with the United Kingdom, *supra,* Art. III (3).

ment should be deemed to derive in the light of such precepts.

Frequently there are general provisions in tax treaties permitting the tax authorities of the respective countries to consult in order to facilitate the carrying out of the convention and avoid double taxation not automatically prevented by the convention. Such a provision can properly envisage consultation to arrive at a fair allocation of income between permanent establishments in the two contracting states in cases where a dispute arises involving allocation which cannot be settled between the local authorities and the permanent establishment involved.

Experience has shown, however, that in the great majority of cases, the taxable profits of a permanent establishment may be determined year in and year out to the satisfaction of the local tax administration without any recourse to assistance on the part of the tax authorities of the other contracting state.

Parent and Subsidiary Companies

Difficulties have arisen because of the belief on the part of tax authorities that a foreign parent company can arrange its relations with a local subsidiary company so as to divert profits from the subsidiary to itself. The amount of the diverted profits escapes not only the tax payable by the subsidiary on its profits but also the tax it may be required to withhold from dividends.

The question of circumventing the diversion of profits by a subsidiary company to its parent company was given considerable study by the Fiscal Committee of the League of Nations, as well as by the negotiators of various tax treaties. This was one of the principal problems to be overcome in the negotiations of the first tax convention between the United States and France which was signed on April 27, 1932, and came into effect on January 1, 1936. The solution adopted was a very simple and logical one, the carrying out of which was entirely within the jurisdiction of the country from which profits were presumed to have been diverted. In the first place, provision was made for correcting the accounts of the subsidiary so as to reflect the diverted profits. In addition it was agreed that any

profit shown by the French tax authorities to have been diverted were, subject to the taxpayers' right to appeal to the French court, to be treated as a dividend paid by the subsidiary to the parent company and taxed at the rate applicable to dividends. There has apparently never been any difficulty in the application of this treaty provision, which now appears in Article 16 of the convention between France and the United States of America, signed July 25, 1939.

Collection Assistance

As regards mutual assistance in collecting taxes, Mr. Sherfy has stressed the need of incorporating such provisions in tax treaties in order to reach a few individuals who in past years have gone to a foreign country to seek their fortune and built up a business, and have there accumulated capital which they have employed in their unincorporated business or have contributed to a local company. Perhaps they have saved their money and acquired real estate from which they derive rents, or made inventions and licensed the patents against payment of royalties.

Under the law of the United States, even though the citizen has a permanent residence or domicile in the foreign country, he is nevertheless liable to the American tax on all income from abroad except his earned income exempt under Section 116(a), I.R.C. Other nations, like Great Britain, France, or Italy, have encouraged their citizens to live abroad permanently and become outposts in the development of their foreign commerce and have never tried to tax nonresidents on their income derived abroad. Inasmuch as the United States is now spending billions to encourage the economic reconstruction of foreign countries, a very small contribution to the practical realization of the objectives of these heavy expenditures would be to encourage Americans to reside abroad and help develop the economic resources of such countries on a permanent basis. To do this would involve exempting them from the United States tax except on income from sources within the United

States. Instead of trying to get other countries to agree to collecting taxes from Americans who have made their homes abroad and are developing American foreign commerce, the United States should amend its own law so as to bring it into line with the legislation of the other countries.

There is another aspect to this problem which the representative of the Treasury has not dwelt upon, namely, the effect of the United States agreeing to enforce foreign tax claims, and the consequent unwillingness of Americans to subject themselves to the jurisdiction of a foreign country to which such a commitment is made. Xenophobia manifests itself fairly generally in tax administrations, and governments often grant a relatively high percentage for denunciation of suspected tax evasion. A taxpayer who objects to a claim is often required first to pay the tax or deposit an amount equal thereto before he can fight the claim in court. Hence, American citizens and companies would be very reluctant to subject themselves to taxation abroad if they felt the United States were bound to place a lien or distraint on their property in the United States at the request of a foreign government which asserted a claim, or to dedicate its courts to the collection of any finally determined foreign tax claim.

Taxpayers' Opposition to Particular Assistance Provisions

As we have seen, the American taxpayer who has been accustomed to declaring his foreign income and taking credit for any foreign tax paid thereon has not been able to understand the Treasury's insistence on incorporating in tax conventions detailed provisions on exchange of information and mutual governmental assistance in the collection of taxes. In the tax conventions with Canada and the United Kingdom, provision is made only for exchange of information, both automatic and in specific cases.[13] However, in the convention with Sweden

[13] Convention with Canada, *supra*, Arts. XVIII, XIX, XX, XXI; Convention with the United Kingdom, *supra*, Art. XX.

each state agrees to go further and enforce tax claims against the nationals of the other state,[14] and in the tax convention of 1939 with France each state agrees to assist in collecting tax claims of the other, except against the former's own nationals.[15]

When the convention with France of October 18, 1946, was made public, American taxpayers were shocked to find that the United States had agreed not only to supply France with information about the income of Americans as well as nationals of France and third countries, but also to enforce in its courts finally determined French tax claims against its citizens and corporations, and apply measures of conservancy to assure the eventual collection of claims not finally determined.[16] This new development of the United States agreeing to serve as informer and tax collector against its own nationals aroused such intense opposition on the part of American taxpayers that interested trade organizations sent representatives to hearings before a subcommittee of the Senate Committee on Foreign Relations.[17] Lengthy discussions which ensued between them and Treasury officials resulted in an understanding as to policy governing mutual assistance provisions in tax conventions. As regards the pending convention with France of October 18, 1946, the mutual assistance provisions were limited so that the United States is not committed to supply information about the income of its nationals either automatically or in specific cases, nor to aid in the enforcement of French tax claims against them.[18]

As a result of the hearings referred to above it was made clear by government representatives that the United States would supply automatically to other countries only such in-

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14 Convention with Sweden, *supra*, Art. XVII.

15 Convention with France, *supra*, Title II, Art. 23.

16 Convention between the United States of America and France of October 18, 1946, Title III, Art. 12.

17 Hearings before a Subcommittee of the Committee on Foreign Relations, United States Senate, Eightieth Congress, First Session on Executive A, Convention with France on Double Taxation, held on January 30, February 6, and April 17, 1947.

18 Supplementary Protocol of May 17, 1948, to the Convention between the United States of America and France, Art. I (1).

formation as it obtains on Form 1042 showing the tax withheld from dividends, interest, and other recurring items of income paid to nonresident aliens and foreign corporations not engaged in business in the United States. However, the taxpayers feel that this practice should be superseded by the more practical one of having the beneficiary of a reduction in rate or an exemption supply the information.

The supplying of specific information in tax conventions is to be subject to certain limitations, but there is need of further clarification and agreement on a fair and practical procedure.

Collection assistance is to be provided only to the extent necessary to prevent nonentitled persons in third states from improperly taking advantage of a reduction in rate or exemptions granted by one state to residents of the other contracting state. Such a provision is found in the tax convention with New Zealand, which was negotiated subsequent to the hearings before the Senate subcommittee and signed on March 16, 1948. The convention stipulates that each of the contracting governments may collect such tax imposed by the other contracting government as will ensure that the exemption or reduced rate of tax granted under the present convention by such other government shall not be enjoyed by persons not entitled to such benefits.[19] Assuming that a resident of New Zealand who receives income from the United States and benefits from a reduction or exemption is actually a nominee of a resident of a third state, he will be required to withhold and pay to the appropriate authorities the partial or full amount of tax due by the resident of the third country.

The more detailed mutual assistance provisions which had already been agreed to in the drafts of conventions with The Netherlands and Denmark were similarly limited in effect with regard to nationals of the state to which the request for assistance in collections is addressed. This was done before they were

[19] Convention between the United States of America and New Zealand, signed March 16, 1948, Art. XVII.

signed; the former on April 29, 1948, and the latter on May 6, 1948.[20]

However, the viewpoint of American taxpayers is that the courts and enforcement machinery of the United States should not be utilized to enforce foreign tax claims even against nationals of the state requesting assistance, or of third states.

Conclusion

The American taxpayer, whether a citizen, resident, or domestic corporation, enjoying the benefit of the credit for taxes paid to foreign countries, or an exemption by treaty from foreign tax in respect of certain items of income, has no real temptation to evade the United States tax and therefore this government has no need to call on foreign governments to aid in collecting its taxes. In order that a taxpayer may obtain the credit for foreign taxes, it is necessary that the foreign government be willing to issue a receipt showing the taxes paid so that the American taxpayer can prove he is entitled to the allowable credit. As regards foreign royalties, interest, and other items exempt under treaties, it is understandable that the American resident should fill out prescribed forms to justify his claim for exemption.

As regards business income, most companies follow the principles of allocation embodied in Section 119 of the Internal Revenue Code and pertinent regulations, which are in harmony with the principle of permanent establishment embodied in tax treaties, and for years they have been able to settle questions of allocation by negotiation with the competent tax authorities of the foreign country without any assistance from the federal authorities in Washington. Hence, it is quite understandable why American taxpayers have not been enthusiastic about the Treasury's efforts to embody in treaties intricate provisions for exchange of information and mutual assistance in the collection of taxes. Looking at the question from the tax collector's

[20] Convention with The Netherlands, *supra,* Art. XXII; Convention with Denmark, *supra,* Art. XVIII.

point of view, it is quite clear that mutual assistance provisions have been of greater interest to foreign governments than to the United States, as the former have long endeavored to reach the income derived from the foreign sources by their residents with undeveloped fiscal consciences.

Whereas the United States has a fairly complete system of information covering taxes withheld from dividends, interest, and other periodical income paid to nonresidents, most other countries have little or no system of information at source. Consequently, the inquiring taxpayer wonders what the United States is receiving in exchange for the shipments in bulk to other countries of information returns filed with the Treasury. Moreover, as regards information in specific cases, when the United States agrees to supply it, the taxpayer feels that it should be clearly understood that the foreign government will exhaust all local sources of information before it asks the assistance of Washington, and, furthermore, the taxpayer insists that he should be notified and given a hearing on whether information should be supplied to the foreign administration.

In so far as assistance in collection is concerned, the American taxpayer is unalterably opposed to having the judicial machinery of this country used to enforce a finally adjudicated foreign tax claim against him, or to authorize the placing of a lien on, or the distraint of, his property as "measures of conservancy" to support a pending foreign tax claim. They feel that the relationship between citizens and the federal government as embodied in the Constitution does not contemplate the federal government spending their contributions to its upkeep in enforcing foreign tax claims against them. Moreover, there is no justification for our courts to enforce a foreign country's tax claims against its own nationals or nationals of third states. These views have been so forcefully advanced that it is believed the Treasury is now willing to limit the collection provisions to those found in Article XVII of the convention with New Zealand cited above; namely, to cases where nonentitled persons may try to receive the benefit of a reduced rate

or exemption in one state by receiving income through a nominee resident in the other contracting state.

However, cases may arise where there is a dispute between administrations over the proper allocation of income or where there is some unusual circumstance not foreseen by the treaty. In such event, it should be possible for the taxpayer to appeal to the appropriate officials of his government, who, by corresponding with the authorities of the other contracting state, can arrive at an amicable settlement of the problem. If the dispute continues, perhaps recourse to some specially established *ad hoc* tribunal or even to the World Court should be provided. In the latter case provision should be made for the proper representation of the taxpayer before the international tribunal, inasmuch as, hitherto, the appearance in an international forum has generally been limited to sovereign states.

In order that double taxation treaties may accomplish their desired purpose of encouraging international trade, they should be predicated on the proposition that most taxpayers are honest. Furthermore, cognizance should be taken of the fact that tax administrations and courts are often prejudiced against the foreigner. Americans operating abroad may be subjected to levies which are arbitrary or inconsistent with the principles of our law, and may have to pay the tax or deposit an amount equal thereto before they can appeal to a court, with the result that a promise of assistance on the part of the United States might place it in the embarrassing position of rendering help in a case where assistance was absolutely unjustified. In view of the fact that there is no common law precedent for enforcing the tax judgments of foreign countries and that there exist strong precedents even as between the States of the Union against enforcing the tax claims of other jurisdictions, certainly the federal government should not by treaty commit our courts to do things that they in their wisdom would not otherwise do.

Such commitments which place the American taxpayer in a disadvantageous position in a foreign country are very likely to discourage Americans from submitting themselves to foreign

jurisdictions. Thus the very purpose of double taxation treaties may be nullified. Emphasis must therefore be placed solely on the rapid conclusion of more agreements to prevent international double taxation.

As regards mutual assistance, cognizance should be taken of the resolution proposed by an official of a foreign government with which the United States has a tax convention, adopted at The Hague Conference of the International Bar Association in August, 1948, which reads as follows:

> Considering that the main purpose of international assistance for the assessment and collection of taxes is to protect the fiscal administration against fraud and evasion of taxation;
>
> Considering that, on the other hand, anti-double taxation treaties are intended to protect the taxpayers against excessive and unreasonable assessments, and to promote international business and investments;
>
> Considering that the International Fiscal Association at its Congress at The Hague 1947 has recommended that in view of the urgency of concluding treaties for the purpose of avoiding the evil of double taxation—an evil of main importance which it considers an ever increasing obstacle for the development of international trade with, and recovery of, war-stricken countries—any secondary object of negotiations, such as mutual assistance in matters of collecting taxes, as a rule should be negotiated on its own merits;
>
> Considering, that requirements in respect of international assistance for the assessment and collection of taxes,—if made conditional for the conclusion of anti-double tax conventions—impede or delay the conclusion of these conventions and transfer negotiations from a sphere of reasonable and fair cooperation into one of sharp bargaining;
>
> Resolves that requirements in tax treaties for mutual assistance in the assessment and collection of taxes are in general incompatible with the reasonable interests of the taxpayer and the broad purpose of eliminating trade barriers.

CHAPTER XLIV

ASPECTS OF THE TAXATION OF FOREIGN CURRENCY INCOME

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A MAJOR PROBLEM in the administration of public law, both at the purely administrative and at the judicial level, is the decision of controversies and the establishment of principles in areas not directly covered by applicable legislation. This problem of the interstitial legislative function of courts and administrative officers is particularly important in income tax administration because of the pervasive influence of the income tax on the business and even on the private lives of the majority of citizens.

The Internal Revenue Code contains no direct reference to foreign currencies. The special problems of American taxpayers doing business or entering into casual transactions involving foreign currencies have been left wholly to administrative and judicial determination and afford, therefore, a test of the adequacy of administrative and judicial law to fill a legislative gap.

Purchases and Other Casual Transactions in Foreign Currencies

The Treasury Department and Tax Court have worked out a generally clear and understandable doctrine to deal with the consequences of foreign exchange fluctuations in such simple situations as direct currency speculations and purchases of

goods with foreign currencies. For tax purposes in the United States, foreign money is not money.[1] It is a commodity like other commodities, subject to the same principle as to valuation and realization of gain or loss on sale or exchange. In the hands of a dealer in foreign exchange, it is an inventory and may be included at the lower of cost or market in closing accounts at the end of the taxable year. In the hands of one not a dealer therein, it is not an inventory and cannot be revalued to the market at the year's end.[2] In this case gain or loss is reflected on realization when the foreign currency is sold, i.e., converted into U.S. currency, or exchanged, i.e., used to purchase some other asset. Gain or loss on an open account in a foreign currency is realized on settled items, determined by applying net debits or credits for the year, at the year's average rate, to the oldest items open at the start of the year.

This doctrine was worked out through the decision, judicial or administrative, of specific problems.

Thus O.D. 419 [3] stated that income for federal taxes must be expressed in United States money, the rate of exchange on the date of receipt governing. O.D. 489 [4] stated that a taxpayer purchasing goods in a foreign country and in a foreign currency should enter their cost in United States money at the market rate of exchange prevailing on the date that the goods were actually paid for. O.D. 590 [5] stated that a domestic corporation buying raw materials from its French stockholders should enter credits for purchases and debits for remittances at the rates prevailing on the dates of the transactions. At this year end the balance in the account should not be restated at the year end rate. Adjustment should be made on closed items only. For example, if transactions for the year showed a net debit in francs against a credit balance at the start, this net debit and its dollar equivalent at the year's average rate should

[1] O.D. 419, 2 C.B. 60; O.D. 459, 2 C.B. 60.
[2] O.D. 834, 4 C.B. 61.
[3] 2 C.B. 60.
[4] 2 C.B. 60.
[5] 3 C.B. 25.

be applied against the oldest credits in the opening balance, at their franc value and historic dollar equivalent, and exchange gain or loss realized to the extent that the net dollar debit for the year was less or more than the dollar equivalent of the franc credits thus satisfied. On this accounting method goods purchased receive their dollar cost basis at the rate ruling on the dates of purchase, not at the rate ruling on their date of actual payment, but there is nothing to indicate that the Bureau of Internal Revenue observed any conflict between O.D. 590 and O.D. 489.

In the appeal of *Bernuth Lembcke Company, Inc.,*[6] it appeared that the taxpayer had acquired 110,000 pounds sterling for the purpose of financing the purchasing of creosote oil in England. At the time the exchange was acquired, the pound sterling was worth \$3.86¼. By the time the taxpayer had purchased merchandise abroad to the extent of 110,000 pounds sterling, the price of the pound had dropped to \$3.50, at which rate the price for the merchandise was paid. The Board of Tax Appeals held that the taxpayer was entitled to an exchange loss for the year in which the sterling was acquired and then paid out for merchandise, while the merchandise took as its basis its cost in pounds converted into dollars at the rate ruling on the date of purchase, which in this case happened also to be the rate at date of payment.

The opposite situation was presented in *Joyce-Koebel Company.*[7] In this case the taxpayer had purchased merchandise in England, the purchase price to be paid in pounds sterling. Payment for the merchandise so purchased was made in pounds sterling acquired in New York. Payments lagged substantially behind purchases. The taxpayer charged purchases and credited accounts payable in dollars at a so-called "normal" rate of exchange for the pound, regardless of the prevailing rate on the date of purchase, whereas remittances were credited to cash and charged to accounts payable at the cost in dollars of the

[6] (1925) 1 B.T.A. 1051.
[7] (1927) 6 B.T.A. 403.

exchange remitted, and the accounts were never reconciled. This procedure resulted in the accumulation of a substantial variation between the balances which appeared to be due on taxpayer's books, in dollars, and the balances which were actually due in pounds. This variation was eliminated in 1920 by adjusting the dollar invoice price for purchases to the actual rates prevailing on the dates of purchase, and by computing a gain in exchange arising from the difference between the dollar-pound rates prevailing on the dates of invoice of goods and the rates prevailing on the dates of payment of the accounts. The Tax Court approved this adjustment, in principle, saying:

> To determine the proper method to be followed in computing income in such a situation as we have here, the transactions must be analyzed. The company purchases goods, the purchase price being payable in pounds sterling. It may pay for those goods at the time of purchase by buying sterling at the then prevailing rate, or it may choose to establish a credit and pay the account later. In any event, the cost of the goods must be arrived at by reducing sterling to dollars at the rate of exchange prevailing on the date of purchase. Appeal of *Bernuth Lembcke Co.,* 1 B.T.A. 1051.
>
> If the company, instead of making payment at that time, makes the purchase on credit, it is investing or speculating in foreign exchange. It may derive a profit or sustain a loss on the exchange operation, but the cost of the goods to it is not affected by such profit or loss. We therefore conclude that the proper method of accounting is to include purchases in the accounts at the rate of exchange prevailing at the date of purchase and to account for any profit or loss in the payment therefor as a separate transaction.

The somewhat haphazard manner in which administrative and judicial law develops is illustrated by these cases. In the *Bernuth Lembcke* case, the Commissioner took a position in 1925 inconsistent both with O.D. 489, holding that goods purchased in foreign currency take as their dollar cost the equivalent of their foreign currency cost on the date of actual payment, and with O.D. 590, holding that such goods take as their dollar cost the equivalent of their foreign currency cost on the date of purchase. The position of the taxpayer, which appears consistent with O.D. 489 and O.D. 590, was sustained by the Court. Under the circumstances of the case, the taxpayer's posi-

tion had resulted in the immediate realization of a deductible loss.

In the *Joyce-Koebel Company* case, the Board of Tax Appeals held that the cost basis of goods purchased in a foreign country was determined by the exchange rate in force on the date of purchase, which in that case preceded the date of payment. This decision is inconsistent with O.D. 489 and follows O.D. 590. It was not required by the result in the *Bernuth Lembcke Company* case, although, perhaps, more consistent with the dicta in that case than the rule of O.D. 489 would have been. The taxpayer's accounting in the *Joyce-Koebel Company* case had been so obviously erroneous and confused that no effective point could be made on the basis of the taxpayer's business practice or normal expectations.

The Commissioner acquiesced in the decisions of both of these cases. O.D. 489 has been modified in effect and a clear line has now been drawn, consistent with the dogma that foreign currency is a commodity like any other commodity, so that taxable gain or loss must be realized on its exchange for other property.

It is still permissible to ask whether these rules make sense from the point of view of the businessman. Let us suppose that an American importer has a contract to acquire commodities in a foreign country at a future date at a fixed price in foreign currency. Under such circumstances the businessman may buy foreign exchange in advance of the date on which he is to use it in order to fix his cost in terms of dollars. If the dollar value of the foreign money should fall before the foreign merchandise is acquired, nothing could be farther from this businessman's normal expectation than to be told that he had realized an immediate gain through speculation on exchange, while the basis for the merchandise purchased was reduced below the dollar cost of the valuta used in its purchase. The businessman had not intended to speculate; he had intended to avoid speculation. Anyone who has difficulty in accepting this approach should talk to businessmen who are not lawyers nor tax ac-

countants, but who are accustomed to foreign exchange transactions. Give them the case of the American importer who buys foreign exchange in advance for the purpose of purchasing foreign merchandise and uses the foreign exchange for this purpose, and the case of the American importer who buys foreign merchandise and thereafter pays for it, acquiring the necessary foreign exchange on the date of payment. Ask whether gain or loss should be recognized on the date of purchase or whether the actual dollar cost should be carried through and gain or loss recognized only when the merchandise is sold. Such inquiries will show that the official Treasury and Board of Tax Appeals position does not make sense to most businessmen.

The weakness of the official view that foreign currencies are merely commodities, like other commodities, may explain the curious result of the *Coverdale* [8] case, which presented on special and unusual facts the tax consequences of borrowing and repaying foreign currency. The Tax Court in that case refused to separate a loss on the purchase and sale of securities from a gain on borrowing and repaying the Canadian dollars with which the securities were purchased, the Commissioner having contended that the currency profit was taxable and could not be offset against the security loss. The result of this case is defensible if the Canadian money is treated not as a commodity but as money, and the currency transaction regarded as a step in the purchase of the securities, so that the eventual United States dollar cost of the Canadian dollars becomes the cost of the securities and the currency profit disappears.

I believe that this analysis is the only one which can justify the result of the *Coverdale* case. It is inconsistent with the conceptual line marked out by the *Joyce-Koebel Company* and *Bernuth Lembcke Company* cases, and the various Office Decisions of the Treasury Department. It may accord much more closely, however, with the common understanding of business-

[8] *Wm. H. Coverdale* (1945) 4 T.C.M. 713 (C.C.H.).

men, and, hence, in the most important sense, with the actual facts of these transactions.

Summarizing the argument to this point, we find that administrative rulings went through several years of confusion, eventually clarified when two Tax Court decisions established a fairly simple and understandable approach to certain foreign currency transactions, treating foreign currency like any other commodity, and requiring realization of gain or loss on its "exchange"—which is to say, on its use to purchase property. It is highly questionable that this approach reflects the actual business sense of the transactions affected or the understanding of businessmen. On the contrary, it is more probable that in both the litigated situations—the purchase of foreign goods with exchange obtained in advance for this purpose, and the purchase of foreign goods with exchange subsequently obtained after the use of the purchaser's credit—the businessman accustomed to such dealings would assume that his cost of goods purchased was the dollar cost of the valuta used, no exchange gain or loss being involved, and that eventual gain or loss should be determined by the difference between the dollar realization on the sale of the goods and their actual dollar cost. In the *Coverdale* case, where the conceptual approach would have resulted in a gain in exchange which—according to the Treasury contention in that case—could not have been offset against a loss on the actual business transaction, the Tax Court refused to follow its own conceptual line.

It may be interesting to consider the possible consequences if the Court had been compelled to decide whether a supposedly separate transaction in foreign exchange resulted in capital or ordinary gain or loss. In the *Coverdale* case, classification of the exchange gain involved in the borrowing and repayment of Canadian dollars as capital gain would have resulted in judgment for the taxpayer. If the gain were so regarded it would have fallen in the same year as the realization of the major part of the capital loss on the Seaboard Airline stock. It became necessary to consider whether or not there was

any distinct gain on the exchange transaction only because the Commissioner contended that this gain was an ordinary gain, thus attempting to tax the exchange gain, while the related securities loss was not deductible because of the limitation on capital losses. It is this unfair result which the Tax Court squirmed to avoid.

Subsequently, the Commissioner has ruled that a gain on a foreign exchange transaction realized by a taxpayer, not a dealer in foreign exchange, is a capital gain. This ruling, if earlier issued and if adhered to, would have obviated the problem of the *Coverdale* case. But consider the difficulties to which this ruling might lead in other cases. Suppose that *Bernuth Lembcke Company* case came up today. In that case the taxpayer, having purchased pounds sterling in advance to finance the purchase of merchandise in England, bought the merchandise and paid for it at a later date when the pound had depreciated in value as against the U.S. dollar. Taxpayer was permitted to take a loss on the exchange transaction, and the cost basis for the merchandise was reduced below the dollar cost of the pounds with which the merchandise was purchased. If the taxpayer's capital loss on the foreign exchange transaction had been nondeductible, the result in the *Bernuth Lembcke* case would have been highly unsatisfactory. When the taxpayer realized ordinary gain in the following year on the sale of the merchandise acquired in England, taxation of the portion of this gain representing the offset to the nondeductible capital loss would be no more defensible than the tax which the Court refused to enforce against Mr. Coverdale on his transaction in Canadian dollars. The Tax Court, unless it felt itself bound by its own prior decisions, would probably endeavor to avoid such a result.

On the other hand, another transaction might show a taxable profit on the currency transaction, governed by long-term capital gain limitations, while the merchandise transaction might show a fully deductible ordinary business loss. This result would hardly suit the book of the Bureau of Internal

Revenue. In England and in Australia, where capital gains not in the taxpayer's trade or business are generally not taxable, and where such capital losses are generally not deductible, the courts have had no difficulty in finding that the currency transactions incidental to the purchase of trading stocks abroad are an integral part of the business operation.

The difficulties which have arisen and which are likely to arise in the future under the present official American view could largely be obviated by giving legal recognition to the business fact that foreign currencies used by traders or investors, for the purpose of buying foreign assets, serve the function of money and not of a non-monetary commodity, and should be treated accordingly. It is only to dealers and to speculators in foreign exchange that foreign currencies are a commodity.

Foreign Branch Accounting

The taxpayer actually engaged in business within a foreign country through a permanent establishment occupies a position which, as a practical matter at least, is quite distinct from that either of the dealer or speculator in foreign currencies or of the importer who acquires goods in the foreign country to supply a business actively conducted in the United States. The officials of the Bureau of Internal Revenue appear to have recognized this difference at a fairly early date. Thus, in 1920 the Bureau ruled that a domestic corporation actually engaged in business in a foreign country should appraise or revalue its assets and liabilities—other than capital assets—in dollars at the prevailing rate of exchange at the end of each taxable year.[9] The position of the taxpayer actively engaged in business in the foreign country is thus recognized as being distinct from that of the taxpayer who makes purchases in the foreign country or engages in casual transactions. Taxpayers not engaged in a branch business in a foreign country, except dealers in foreign exchange, may not realize gain or loss on foreign currency on the

[9] O.D. 489, 2 C.B. 60.

basis of a year end inventory, but must wait until its disposition.

The special position of the taxpayer operating the foreign branch, although apprehended by Bureau officials, was not thoroughly analyzed. In the same volume of the Internal Revenue Bulletins, and on the page following the Office Decision requiring the taxpayer with the foreign branch to reappraise foreign currency assets at the year end, appears a ruling [10] as follows:

> A domestic corporation has a branch office in London which keeps a separate set of books in English currency and renders a report at the end of the year as to the profits. During the year, whenever the branch office has on hand more money than is needed for regular expenses, a remittance is made to the home office.
>
> HELD, that the net profits of the London branch for the year should be computed in English currency. From the total profits for the year should be subtracted the total amount remitted to the home office during the year, all expressed in English currency. To determine the equivalent of the profits in terms of United States money, the amounts remitted should be converted into United States money at the rate of exchange in effect at the date such remittances were made. The balance of the net profits, expressed in English currency, should be converted into United States money at the rate of exchange as of the end of the taxable year, regardless of the fact that the profits may not have been remitted to the home office.

Inconsistencies between these two rulings, apparently not originally observed by the Chief Counsel's Office, were resolved by litigation in the case of *Frederick Vietor & Achelis* v. *The Salt's Textile Manufacturing Company*.[11] This was a proceeding brought by the receiver in a pending equity suit for adjudication of an income tax claim asserted by the United States. The French branch of *Salt's Textile Manufacturing Company* during 1919 earned a profit in French francs. It would appear that accounting in accordance with O.D. 550, quoted next above, would show some profit in dollars, representing the profit remittances for the year, if any, in the U.S. dollar amount actually received, plus any balance of the French franc profit

[10] O.D. 550, 2 C.B. 61.

[11] (D.C. Conn., 1928) 26 F. (2d) 249; 1 U.S.T.C. 1661.

not shown as remitted on the foreign currency accounts, converted into dollars at the rate ruling at the year end. It would be possible to show a loss in dollars against a gain in francs under this accounting procedure only if remittances from the United States to France during the year exceeded remittances from France to the United States, if this excess were regarded as a negative remittance of profits, and if such negative remittance of profits, expressed in dollars, should exceed the total profits of the French branch converted to dollars at the year end rate. The Court indulged in no such farfetched accounting manipulations, but rather followed the simpler procedure of computing the profits in dollars after converting all of the current assets and liabilities, and not merely the foreign currency profit, into U.S. dollars at the year end closing rate. The Bureau has since accepted this method of computation, which is in accord with O.D. 489.

Despite initial confusion in the administrative rulings, a rule for branch foreign currency accounting was thus established by judicial decision and subsequently accepted by administrative action, which rule is in accord with ordinary commercial practice, and it is largely satisfactory.

One situation under which the rule of the *Salt's Textile Manufacturing Company* case might prove unsatisfactory is potentially quite important. It was held in that case that no foreign tax credit could be taken for excess profit taxes paid to France in the year in which the company showed a dollar loss arising from its French business. This conclusion, disputable under the Revenue Act of 1918, would be unquestionable under the present tax credit limitations of I.R.C., Section 131. The accounting rule of the *Salt's Textile Manufacturing Company* case may therefore result in foreign currency profits in years of U.S. dollar loss, with foreign income taxes paid and available, but not allowable for foreign tax credit, while other years might show dollar profits and foreign currency losses, with income taxes payable in the United States and no foreign tax credit available. This difficulty is one for which the adminis-

trative and judicial practice can hardly be blamed. It appears to be inherent in the provisions and limitations of the foreign tax credit section of our Internal Revenue Code, as applied to foreign branch operations. It might be cured by legislative action providing for a carry-forward of unused foreign tax credit, or by more drastic changes in United States taxation of foreign branches which would treat foreign permanent establishments essentially as though they were foreign corporations.

Blocked Foreign Income

The rules applicable to foreign currency income, while subject to criticism, are at least fairly well settled in their application to situations in which the foreign currencies involved are remittable, so that actual rates for conversion and exchange are determinable at the various relevant dates. In recent years American foreign traders have seldom faced this happy situation. Blocked and nonconvertible foreign currencies are the rule today, and present new problems. Here, again, there is no legislative guidance, and here neither administrative nor judicial lines of authority are clearly established.

The first important case dealing with blocked foreign currencies was *International Mortgage & Investment Corporation* v. *Commissioner*.[12] The petitioner in this case was a Maryland corporation formed to deal in German securities. The dollar capital of this company was imported into Germany and used to purchase German mark mortgages on German property during the years 1926 to 1930. On July 13, 1931, the German banks were all closed, and before they reopened, on August 1, 1931, the German "Devisen Ordnung" prohibited the transfer out of Germany of marks received on repayment of capital sums without permission of the German Foreign Office. Between this date and December 31, 1931, taxpayer collected considerable sums in German marks on the repayment of its mortgage investments, at a profit of 545,393.52 German marks. Taxpayer's agents in Germany were unable to pay taxpayer any of the

[12] (1937) 36 B.T.A. 187.

proceeds of mortgages collected subsequent to the "Devisen Ordnung." The money was apparently entirely blocked until December 30, 1931, on which date a regulation permitted the owner of blocked marks to reinvest in Germany on a long-term basis with the written consent of the Foreign Exchange Office, provided that these reinvestments would be turned into a blocked account. The Board of Tax Appeals held that as to funds received prior to July 13, 1931, the excess of payments received over the cost of the obligation satisfied, converted from dollars to marks at the then ruling rate of exchange, were taxable in the United States, whether or not in fact remitted. The taxpayer was not required to recognize any profits earned after July 13. As to these blocked profits, the Board said in part:

> Measured in marks, the petitioner had income from its business in Germany, but income for our Federal income tax purposes is measured only in terms of dollars. *James A. Wheatley*, 8 B.T.A. 1246; *North American Mortgage Co.*, 18 B.T.A. 418; *Frederick Vietor & Achelis* v. *Salt's Textile Manufacturing Co.*, 26 Fed. (2d) 249; *New York Life Insurance Co.*, 24 B.T.A. 1217; aff'd., 65 Fed. (2d) 345; certiorari denied, 290 U.S. 682. The excess of amount realized over cost of the mortgages during that period was not measurable in terms of dollars. None of the marks received by the petitioner's agents representing repayment of mortgage principal could be removed from Germany either physically or by way of credit during the remainder of the taxable year. The dollar equivalent of those marks could not be obtained. The petitioner did not have unrestricted use and enjoyment of the marks. It had a claim against its agents for the amount of the marks but it could not remove the credit or the marks from Germany. It could not use the marks to retire its bonds as it desired to do. Just at the end of the year there was a regulation passed which permitted reinvestment under certain circumstances. But proceeds of such reinvestment would likewise be blocked and the regulation in no way benefited the petitioner during 1931. The petitioner had no way of obtaining these funds during 1931. It tried to have the funds released, but was unable to have any of them released until a number of years later. Thus it appears that these particular marks during 1931 were subject to a very serious restriction and were in no sense the equivalent of free marks. It was, therefore, improper to compute a gain to the petitioner from the repayment of the mortgages by translating the excess marks received into dollars at the rate of exchange applicable to free marks. The petitioner had no gain during 1931 from the receipt of the blocked marks.

The Commissioner acquiesced in this decision.

The *International Mortgage & Investment Corporation* case is still the leading authority on foreign currency blocked income.[13]

Credit & Investment Corporation v. *Commissioner*,[14] decided in 1942, again involved blocked marks received by an American taxpayer in payment of securities purchased in Germany. It appeared in this case that in 1936 there was a market for blocked marks in New York, although at a rate substantially less than the official rate of exchange. The Board held that the taxpayer realized a sum equal to the amount of foreign currency received on the sale of German securities in 1936, converted into dollars at the free rate determined by the market in New York. This sum, reinvested in Germany, then represented the cost of other German securities sold in 1937. While it is not entirely clear that the taxpayer's marks could in fact have been converted into dollars in 1936, the burden of proof was on the taxpayer, taxpayer failed to meet it, and the Board rightly held that taxable income was realized, measured by the free market rate of exchange.

Before the *Credit & Investment Corporation* case was decided, the B.T.A. decision had been handed down in the case of *Phanor J. Eder, Violet L. Eder,* and *James P. Eder*,[15] the first step in litigation which has cast doubt upon the rule which the *International Mortgage* and *Credit & Investment Corporation* cases seem to make clear. Phanor J. Eder was a lawyer practising in New York and specializing in Latin-American law. He spent the majority of his time in New York, but a substantial part of it in Colombia. With his wife, Violet, and his son, James, he was the owner of a Colombian holding company, which was a foreign holding company within the meaning of Supplement P of the Internal Revenue Code. This Colombian company earned substantial income in Colombian pesos, about two-thirds of which was not declared in dividends

[13] We hope!
[14] (1942) 47 B.T.A. 673.
[15] (1942) 47 B.T.A. 235.

in 1938, the year under review. If additional dividends had been declared, the proceeds could not have been remitted. Petitioners contended in part that the tax on undistributed income of foreign personal holding companies was imposed on the theory of constructive receipt, and that since the petitioners could not have transferred any dividends which might have been declared from the Republic of Colombia to the United States in 1938, there could be no constructive receipt, and hence no justification for application of the tax. After discussing the history and purposes of the foreign personal holding company act in some detail, the Board of Tax Appeals sustained the Commissioner, saying:

> *International Mortgage & Investment Corporation,* 36 B.T.A. 187, involving the taxability to a United States taxpayer of his "blocked" German marks in Germany, *North American Oil Consolidated* v. *Burnet,* 286 U.S. 417, and other cases upon which petitioners rely, are not in point. They were all decided squarely under the doctrine of "constructive receipt" and are not premised upon any specific legislation, as are the present deficiencies.

Petitioners appealed this decision to the Circuit Court of Appeals for the Second Circuit, where the decision of the Board of Tax Appeals was modified.[16] The C.C.A. affirmed the Board in holding that the undistributed Supplement P of the Colombian company was taxable to the shareholders, but remanded the case to the Board to permit taxpayers to introduce evidence as to the fair value of blocked Colombian pesos. The opinion of Circuit Court Judge Frank quite characteristically covered considerable ground and is susceptible of various interpretations. Judge Frank said in part:

> The evidence does not make it clear whether or not owners of "blocked" pesos could have sold them for dollars to citizens of this country wishing to invest or spend the pesos in Colombia. But even if we assume that such a transaction was not lawfully possible under the laws of Colombia, or that there would have been an obligation to return to Colombia the dollars thus received, still there can be no denying that the taxpayers could have invested, or spent, the "blocked" pesos in Colombia and, as a result, could there have received economic satisfaction. The taxpayer, Phanor J. Eder,

[16] (C.C.A.-2, 1943) 138 F. (2d) 27.

must actually have needed to expend some pesos in Colombia during a portion of the taxable year.

Judge Frank also relied on the specific purpose of the foreign personal holding company act, saying:

> That the result under the statute here before us may be harsh is no answer to the government's position; the purpose of Congress was to deal harshly with "incorporated pocketbooks," and the motive of a particular taxpayer who has such a "pocketbook" we have held to be irrelevant.

This leaves in the air the question whether the controlling factor in the case was Mr. Eder's economic satisfaction at being able to spend these pesos in Colombia or the harsh purpose of Congress in enacting the particular provision of the Code on which the Board of Tax Appeals was clearly relying. Incidentally, it does not appear that Mrs. Eder ever went to Colombia or that she derived any satisfaction from Mr. Eder's ability to go to Colombia and spend pesos.

On remandment, the Tax Court found the value of blocked pesos at one-half the value of free pesos, and entered decision accordingly in conformity with the judgment of the Appellate Court. Less than one month later, in *United Artists of Japan* v. *Commissioner,*[17] the Tax Court directly followed its decision in *International Mortgage & Investment Corporation,* distinguishing *Credit & Investment Comporation* on the ground that the evidence in the *United Artists* case established that the blocked yen could not have been made available through a free market in the United States, and distinguished the *Eder* case as follows:

> In that case, the taxpayer urged the applicability of the *International Mortgage & Investment Corporation* case, but this Court held that that case was not in point as it was not premised upon any specific legislation as was the deficiency in the *Eder* case, to wit, section 337(b) of the Revenue Act of 1938. As this Court pointed out in the *Eder* case at page 240 of its opinion, Congress, in enacting section 337 of the Revenue Act of 1938 and Supplement P in which that section is included, did not make the legal transfer to the United States of the distributed earnings of a foreign personal holding

[17] (1943) 3 T.C.M. 574 (C.C.H.).

company a condition precedent to the levying of the tax. Distribution was assumed by the statute and this Court went on to state that "Assumed distribution even when actual distribution was legally impossible, has been held to properly support other income taxes." We have no such statute or assumed distribution in this case and the principle does not here apply.

Edmund Weil, Inc. v. *Commissioner*,[18] on appeal from a decision of the Tax Court not officially reported, involved a tax asserted on a capital gain resulting when the taxpayer dissolved a Brazilian subsidiary and loaned the proceeds to a new partnership to be formed in Brazil by the individuals who had previously been the minority shareholders in the Brazilian company. Taxpayer defended, in part, on the ground that the proceeds in liquidation were blocked in Brazil. The Court held for the Commissioner on the ground that the taxpayer had failed to prove his contention that the proceeds were blocked, but added the following dictum:

> The taxpayer objects to the decision of the Tax Court principally on the ground that there was no taxable capital gain since it "could not export the gain to the United States." Even if this were so, the taxpayer could not succeed and we ought to do no more than remand so that evidence might be presented to show some other basis for measuring an evident gain than current rates of exchange—just as we did in *Eder* v. *Commissioner*, 138 Fed. (2d) 27 (43-2 USTC Par. 9519).

The last decision in this field, to date, is that of the Tax Court in *Max Freudmann, et al.*[19] Max Freudmann and his brother Henri were partners in the diamond business. They escaped from Europe to America and set up businesses again in Canada and later in New York. One issue involved the taxability of profits earned by the partnership in Canada, after the partners had established their residence in the United States. It appears that the partners sought permission to transfer the profits of their Canadian partnership to the United States, but that this permission was denied as to the calendar years 1940 and 1941 involved in the Tax Court proceeding. The taxpayers contended that they were not taxable on this Canadian part-

[18] (C.C.A.-2, 1945) 150 F. (2d) 950.
[19] (1948) 10 T.C. 775, No. 105.

nership income under Section 42 of the Internal Revenue Code and under the Treasury Regulations thereunder relating to constructive receipt. The Commissioner contended that they were taxable by reason of Section 182, providing:

> In computing the net income of each partner, he shall include, whether or not distribution is made to him. . . .
>
> (c) his distributive share of the ordinary net income or the ordinary net loss of the partnership, ...

The Tax Court considered the two sections of the Code and stated that of the two Section 182 had more specific application to the case at bar. The Tax Court then reviewed the decision in the *International Mortgage & Investment Corporation* case with apparent approval, but held that the *Freudmann* case was distinguishable on the same theory as the *Phanor J. Eder* case. The Court said:

> In the instant proceedings petitioners offered no proof as to what the laws of Canada were relative to the transmission of funds from that country to the United States. At the time Henri arranged with Canada to bring the $90,725.75 representing either the cost or value of the diamonds petitioners had shipped from Antwerp to Canada in 1939, he was told that petitioners would not be permitted to bring any further funds from Canada to the United States during the war. As to the nature of these restrictions we were left uninformed, but we will assume they were effective to prevent the transmission of any of these funds to the United States. However, there is no evidence to show that petitioners did not at all times have free use of the income in question in the conduct of their partnership business in Canada.
>
> It is our opinion, and we hold, that under the plain provisions of section 182(c) I.R.C. and upon the authority of the *Eder* and *Weis*[20] cases, supra, that petitioners are taxable for the calendar years 1940 and 1941 on the respective amounts of income from the Canadian partnership mentioned in the parts of the stipulations of facts set out in our findings. Cf. *Heiner* v. *Mellon*, 304 U.S. 271 (38-2 USTC Par. 9311).

Such is the state of the record today. The taxability of blocked currency income now rests upon whatever inferences can be drawn from these six judicial decisions, entirely unaided by any regulation or published ruling of the Bureau of Internal Revenue. The *International Mortgage* and *Credit & Invest-*

[20] *Weis* in the official report but *Weil* apparently intended.

ment cases appear to lay down a simple and satisfactory rule to the effect that foreign currency income, which can in no way be converted into U.S. dollars, does not give rise to taxable income in the United States, whereas foreign currency income which can in any way be converted into United States currency gives rise to taxable income in the United States measured by the realistic rate at which the income can be converted. The rule so formulated would appear to be subject to only one question—whether black markets, which is to say, illegal channels for conversion of foreign funds, must be taken into account in determining the convertibility of unconverted foreign currency. If squarely faced by this question, it is difficult to see how our Treasury could fail to hold that illegal channels for conversion are irrelevant, except that income actually converted into U. S. currency is taxable to the taxpayer without inquiry as to the legality of the means employed. Only this decision would be consistent with the general approach of our Treasury to income resulting from illegal activities.

There is controversy as to the extent to which the *Eder* and *Freudmann* cases have undermined this rule. The Tax Court apparently regards its decision in the *Eder* case as resulting solely from the special requirements of Supplement P. Mr. Sidney Roberts, however, in a recent article [21] has pointed out the logical weakness of this position with considerable force. Supplement P is applicable only to that portion of the income of a personal holding company which is not declared as dividends. If the holding of the *Eder* case should be regarded as applicable only to Supplement P net income of the company, while apart from Supplement P the *International Mortgage* case would have been controlling, we would arrive at the astonishing result that the Eders were taxable on the undistributed earnings of the Colombia company, but not taxable on the dividends declared, and that all liability for tax on the earnings of the Colombia company could have been obviated by

[21] "Taxability of Income Received in Blocked Currency," *Journal of Accountancy*, (September, 1948).

declaring all of these earnings in dividends, which dividends, being blocked, would have been governed by the general rule of the *International Mortgage* case and, hence, would not have resulted in liability for tax. Mr. Roberts suggests that the controlling factor in the case was Eder's ability to use Colombian pesos in Colombia, coupled with the fact that he must have some actual requirement for Colombian pesos for his own expenses, in that he spent part of his time in Colombia. This line of approach is not particularly helpful. In the first place, the Court did not distinguish among the three Eders, and there is no indication that Mrs. Eder or her son had any occasion to go to Colombia or any personal use for Colombian pesos. To the extent that Mr. Eder had use for Colombian pesos, it seems probable, in view of the fact that his residence and principal place of business were in the United States, that his peso requirements were for deductible business expense. If this is true, a satisfactory result could be reached on this aspect of the case by holding that otherwise deductible expenses payable in Colombian pesos are not deductible for United States tax purposes as along as they are offset by blocked peso income.

Looking at the question more largely, the narrow ground suggested by Mr. Roberts would seem entirely inapplicable to the blocked income of an incorporated business. Corporations are not supposed to derive satisfaction through the squandering of foreign currencies. Any money which a corporation spends should be business expense, and the only satisfaction which a business corporation is entitled to recognize is the satisfaction experienced by its shareholders due to an increase in corporate wealth or a distribution of corporate earnings. To the extent that there is any validity in taxation based on economic satisfaction arising from entirely nonconvertible foreign currencies, it should be confined to taxpayers resident in the foreign country or sojourning there for nonbusiness purposes.

The *Freudmann* case, again, appears to be based primarily on the theory that a specific provision in the statute, in this case the section relating to the taxation of undistributed part-

nership income, overrides the general provisions applicable to realization and constructive receipt. However, the Tax Court was a little less clear in this case and its reference to the decisions of the Circuit Court of Appeals in the *Eder* and *Weil* cases, together with the reference to *Heiner* v. *Mellon,* may suggest that some broader principle was also involved.

In fact, the entire discussion of general versus specific provisions in the Revenue Code seems quite wide of the mark. The rule of the *International Mortgage Corporation* case does not rest directly on any provision of the Code, general or specific. It rests rather on a much more basic underlying conception that "income for our Federal income tax purposes is measured only in terms of dollars" and no gains represent taxable income unless they are measurable in the money of the United States. Foreign currencies which cannot in any manner be reduced to United States money are not so measurable. The possibility that they might be expended for assets in foreign countries, which assets in turn would have no market save in nonconvertible foreign currencies, is quite irrelevant. It is possible, as in the *Eder* case, to figure out how much rice you can buy in Colombia with a peso and how much rice you can buy in New York with a dollar, and in this manner to determine a theoretical cross rate. You do not, in fact, determine anything about the value of Colombian pesos in this manner, excepting, perhaps, from the point of view of some individual who wants to eat rice in Colombia. For the American businessman and even more clearly for the American corporation, interested in U.S. dollar income, such a comparison is meaningless. It is meaningless because to one who is trading in rice and not eating it, blocked Colombian rice is no more like free American rice than blocked Colombian money is like free American money. The question still is whether, directly or indirectly, the Colombian asset can be reduced to American money.

As for the discussion of constructive receipt in the *Eder* and *Freudmann* cases, this issue is strictly a red herring. Con-

structive receipt was first discussed by *Eder,* as petitioner, who advanced the theory that taxation under Supplement P was based upon constructive receipt. This argument is no more than a figure of speech. In holding for the Commissioner, the B.T.A. stated that taxation under Supplement P rests upon the specific requirement of the statute, which is true, and then added that the *International Mortgage* case was "decided squarely under the doctrine of 'constructive receipt,'" which is unqualifiedly false. The doctrine of constructive receipt deals with facts which justify waiving the requirement of actual receipt of income available to "cash basis" taxpayers. It had no application whatsoever to the case of *International Mortgage & Investment Corporation,* a taxpayer on the accrual basis.

In *Max Freudmann, et al,* the Court spent several paragraphs rebutting an argument for petitioners relying on the constructive receipt regulations under I.R.C. Section 42. The Court held that Section 182, dealing with computation of the net income of partners, was more specific in its application to the case at bar, and therefore took precedence. But the Court, adding that it made no difference in the case at bar whether taxpayers were on a cash or an accrual method of accounting, in effect indicated that the discussion of constructive receipt was irrelevant.[22]

The *International Mortgage* case rests upon a principle far more fundamental than I.R.C. Section 42, or I.R.C. Section 182, or any other section dealing with accounting method and timing of accrual or receipt. This principle is a gloss on I.R.C. Section 22(a) that income is not to be included in the measure of taxation in this country unless its value is measurable in the currency of this country. It has been held in the past that the

[22] The manner in which this case was argued may be explained by the observation of Mr. Sidney Gelfand, writing on the Freudmann case in the November, 1948, issue of *Taxes,* at p. 1017: "In view of the lower surtax rates in effect and the lower surtax brackets to which the taxpayers were subject in the earlier years, as well as the forgiveness feature for 1942, the finding of the Court was well received by the taxpayers."

Apparently the Treasury won a Pyrrhic victory on this issue, but in such devious and whimsical fashion precedents are established and case law develops.

receipt of assets situated in the United States, for which there is no market in United States currency, does not give rise to taxable income.[23] This should be no less true of assets situated in a foreign country for which there is no market in United States dollars.

We are forced to this conclusion: that there is at present no clear judicial ruling as to the taxability of blocked foreign currency income. This situation is exactly the one which should be anticipated when the attempt is made to fill in a large gap in statutory law by decision of particular cases, where the officials representing the government, no less than the taxpayers, are concerned primarily with the immediate pecuniary result of each particular case, and secondly, if at all, with the establishment of rules of general application which will produce sound results not only in the case under consideration but in other cases which reasonable ingenuity and knowledge of business problems should enable them to anticipate. As a result, American businessmen who are attempting to carry on our foreign trade in many troubled areas of the world must invest their capital and their efforts and take all risks, without even the assurance that our government will forbear from the current collection of U.S. dollar taxes on foreign currency paper profits which today cannot be remitted and tomorrow may well be lost.

The solution of this problem will not be found in efforts, however ingenious, to reconcile the *Eder* and *Freudmann* cases with other and sounder authority. The task of the advocate may require such specious reconciliation, but the scholar, legislator, or administrator should recognize that the decisions are in conflict. The Internal Revenue Service would do well to eschew opportunism and recognize the authority of *International Mortgage & Investment Corporation* in all cases in which United States residents or corporations receive funds or assets abroad which can in no way be converted into United States dollars.

[23] See Magill, *Taxable Income* (rev. ed.) at pp. 125-27, 228-32.

Conclusion

Three aspects of United States income taxation, as affected by foreign currency operations, are discussed in this paper. In the first, the case of purchases and other casual transactions in foreign currency by taxpayers not in business through foreign branches, a fairly clear line has been worked out by judicial and administrative decision, but it is highly doubtful that this line satisfactorily meets the business problems presented. In the second, the case of foreign branch accounting, a definite and reasonably satisfactory line is indicated, and further improvement would probably require legislation. In the third, the matter of blocked profits, the course of litigation, with the Commissioner and the taxpayer each diligently striving to protect his interest in each litigated case, has resulted in total ambiguity and mystification on a subject of vital importance to a substantial segment of American business. It is easier to point out flaws than it is to suggest cures. It appears, however, that the present unsatisfactory situation could have been improved by the bold exercise of the Commissioner's quasi-legislative powers in the issuance of regulations with the full cooperation and direct participation of interested business and professional groups as envisaged under the Administrative Procedures Act.

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